THE SUB-PRIME LOAN CRISIS IN NEW YORK APARTMENT HOUSING

How Collapsing Predatory Equity Deals Will Harm Communities and Investors in New York City

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Summary:

- There has been a dramatic shift in the market for affordable rental housing in New York City as developers backed by Wall Street-type private equity funds have targeted rent-regulated buildings with an investment strategy that has become know as "predatory equity" because of the large numbers of tenants who are being illegally displaced. In only a few years, these predatory equity developers have purchased an estimated 90,000 units of affordable rental housing.
- The structure of many of these real estate deals is unsupportable, and there is a growing danger of default that may lead to a new sub-prime loan crisis for apartment buildings in New York City. Analysis by ANHD finds that a remarkable 60% of the predatory equity loans have been placed on a watch list by the loan servicer for being in danger of default. These loans are three times more likely to be on the watch list then non-predatory equity loans in the same loan security pools, and could represent up to 54,000 apartments that are at risk.
- A detailed analysis by ANHD reveals that these loans (classified as "commercial loans" because they are for multi-family buildings) and the real estate deals they are backing are highly speculative and bear sharp similarities to the sub-prime crisis that is affecting the single-family residential loan market.
- This new commercial loan sub-prime crisis 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. These distressed projects in turn depress the block in which they are located, and the neighborhoods in which they are concentrated. This crisis may also have a destabilizing impact on local commercial loan markets, reducing the availability of healthy investment in affordable housing. Investors in the commercial mortgage-backed securities backed by these mortgages may also be harmed.
- Responsibility for this crisis falls on many parties, including the developer and their private equity partners, the lender, the security underwriter, and the credit rating agencies.
- Local policy makers must take an active role in defusing the impact of this next sub-prime crisis by pro-actively protecting the rights of tenants in these buildings, monitoring building conditions and owner financials, and committing resources to ensure that this hard-to-replace affordable housing does not fall into abandonment and disrepair so that tenants and communities are not dragged down. National policy makers must develop regulations for commercial lending markets and credit rating agencies that take into account the realities of lending on apartment buildings.

Introduction

In our May, 2008 white paper *The Next Sub-Prime Crisis: How Predatory Equity Investment is Undermining NYC's Affordable Rental Housing*, ANHD described the new phenomenon of "predatory equity" and explored one serious problem with this investment strategy – the destruction of affordable rental housing through aggressive harassment of tenants. In this follow-up report, we explore a second threat – the serious danger to the stability and viability of working class neighborhoods in New York City, as well as lenders, investors, and commercial credit markets. This paper cites evidence from loan servicer reports that the speculative nature of predatory equity loans makes them three times more likely to be in danger of default then similar, non-predatory loans. We also provide a detailed analysis of the underwriting criteria of a cross section of loans including some high-profile real estate deals to show why they are speculative and likely to fail. We will also outline some possible solutions, including the need for an *ad hoc* intergovernmental working group to work to pro-actively preserve this at-risk affordable housing by supporting tenants and preservation purchases.

What is Predatory Equity?

In recent years, neighborhoods around New York City have seen a dramatic rise in the harassment of tenants as landlords try to illegally remove working families so they can raise the rent. 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 private equity-backed investors who 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 illegally displacing tenants and undermining affordable rents. Many of the lending institutions that are providing the huge loans for the purchase of these buildings are pooling and re-selling the loans in mortgage-backed securities.

Both the private equity funders and the lending institutions are aware, or should be aware, that illegal 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 – almost 10% - 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. (For more detail, see the May, 2008 white paper *The Next Sub-Prime Crisis: How Predatory Equity Investment is Undermining NYC's Affordable Rental Housing*.)

The Developing Threat in the New York City Commercial Loan Market

The destruction created by single-family <u>residential</u> sub-prime loans, and the investment instruments backed by those loans is now well understood. First, lenders made unwise loans, often justified by a borrower's aggressive future income projections. These sub-prime loans were based on unjustified assumptions, or outright falsehoods, about the borrower's ability to repay the loan. Borrowers are now defaulting at a rate that threatens the future of countless families and communities. Second, lenders then sold those loans to back various investment instruments including residential mortgage-backed securities and other collateralized mortgage obligations. The goal of these investment instruments was to raise more capital to lend, which was successfully accomplished, and to hedge the risk of such aggressive lending. This second goal has turned out to be a failure of historic proportions. Rather then hedging risk, the multiple layers of mortgage-backed securities, collateralized mortgage obligations, credit default swaps, and other complex financial technologies spread the risk around like a virus. When mortgage default rates went beyond analysts' expectations, investors who bought any of the multiple layers of the instruments lost billions and credit markets collapsed.

New York City is dominated by multi-family apartment buildings. Loans on these buildings are classified as commercial loans. Like the residential mortgage market, these commercial loans are used to back various investment instruments including commercial mortgage-backed securities and other collateralized mortgage obligations. These "predatory equity" loans are the equivalent of residential sub-prime loans.

Like sub-prime loans, these commercial loans are irresponsible because in many cases the borrower does not have a reasonable chance of paying them back. Furthermore, these commercial loans are speculative because they are based on an unrealistic potential future rental income from the building. The industry term for this loan strategy is "transitional", meaning that a building producing a moderate income can rapidly be transitioned to produce a far higher income. In a rent regulated building where annual rent increases are set by law and are relatively moderate, dramatic rent increases can only be taken when an apartment becomes vacant. The only way to rapidly "transition" a building is to generate an unusually high rate of turnover by moderate-rent paying tenants. This is the stark, methodical harassment used by private equity backed developers to generate the tenant turnover that has earned the name "predatory equity".

The impact of predatory equity in New York City's rent regulated housing stock is enormous. In only a few years, predatory equity developers have purchased an estimated 90,000 units of affordable rental housing. This represents more than 10% of our rent regulated housing[1]. As with residential loan markets, these predatory commercial loans have been re-packaged in various mortgage-backed investment instruments. This is designed to raise more capital to lend, and to hedge the risk. But, as with the current residential sub-prime crisis, if the default rate of predatory equity loans exceeds analysts' expectations, the risk may be spread like an infection. In turn, there is real potential to do great damage to residents, communities, investors, and commercial loan markets.

The Danger of Predatory Equity

The growth in rental income from a well-managed rent regulated building can be expected to rise in a steady, but moderate line. Under rent regulation, leases must be renewed and rents can only be increased by a moderate amount (as set by a city Rent Guidelines Board) with each lease renewal. Although dramatic increases in rent can be taken on vacant apartments, the "natural" turnover rate for tenants in rent regulated apartments averages between 5% -10%, which does not translate to the huge jump in rental income that speculative purchasers need to satisfy their debt obligations. Two things can happen if a loan is underwritten on the assumption that a landlord can achieve a vacancy rate far beyond the historic average:

1. Either the assumptions are correct and the landlord actually can harass out enough of the tenants to increase the rent roll 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 and whoever made the loan or bought into investment instruments based on the loan is likely to lose.

[1] Based on a 2008 report from the New York State Department of Housing and Community Renewal there were 850,000 rent-regulated apartments in New York City.

For the thousands of working and middle-class households who are victims of this business model, no outcome is favorable.

The Crisis of Speculative Commercial Loans – Projecting the Danger of Default

ANHD has obtained detailed loan underwriting information for the 35% (27,000) of the predatory equity-backed deals that were purchased with bank loans (first loans) that were then pooled in a commercial mortgage-backed security. For these loans, detailed information about the underwriting assumptions on which the loans were based is available by searching public records of the Securities and Exchange Commission (SEC).

ANHD also obtained information from the Trepp financial data Service Company that tracks which of these loans was placed on a "default watch list" by the loan servicer. A full 60% of these loans are on the servicer's default watch list. This compared to a watch list average of 20% of all other loans that were pooled in commercial mortgage-backed securities in the same year.[2] This makes predatory equity loans three times more likely to be on a default watch list than other commercial loans in the same security pool.

Although we only have detailed underwriting and servicer's watch list information for the 35% of predatory equity loans that were pooled into securities, it is reasonable to assume that most of the 90,000 regulated apartments purchased by predatory equity developers share similar characteristics. A 60% watch list rate therefore suggests that up to 54,000 New York City apartments may be in danger of default.

This default crisis will have 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 in which they are located, and the neighborhoods in which they are concentrated. Another very real consequence of a default crisis is that local credit markers may be destabilized, and financial institutions will be unwilling to make the healthy investments that are necessary in affordable rental housing.

Investors in collateralized debt obligations may 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 sub-prime residential loan market, it is not yet clear what will occur in the commercial loan market. *Appendix A is a list of commercial mortgage backed securities that could be exposed to predatory equity defaults.*

Understanding the Default Risk - Why Predatory Equity Loans are Speculative

The danger of default in these predatory equity loans was not an unforeseeable accident. As in the residential sub prime 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 has examined the underwriting for ten rent stabilized multi-family residential building portfolios that were purchased by private equity firms and financed with mortgages that were subsequently securitized in commercial mortgage-backed securities. This underwriting information, while incomplete, does divulge financing terms and underwriting assumptions that cannot be obtained from public records for non-securitized loans. These securitized loans have many similarities. All are interest-only short-term balloon loans – five and seven year terms are common and none exceed ten-year

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

terms. All are from lenders that have not played a large role in financing acquisitions of New York City's rent stabilized multi-family buildings until recently. All posit a substantial increase in Net Operating Income (NOI) at purchase to an Underwritten (UW) NOI 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 loans are to owners who state that they will achieve these higher rents by undertaking both apartment improvement increase (so-called 1/40th) and Major Capital Improvements (MCIs or 1/84th increases) on vacant apartments and establish reserves to pay for these costs.

Specific examples of aggressive underwriting revealed in the SEC "Free Writing Prospectus" filings include:

- Inflating Income Projections: In the frothy underwriting era of 2006-2007, projected income, not actual income was used to justify inflated loan amounts. This allowed projects like the Riverton to acknowledge an at-purchase Debt Service Coverage Ratio of .39x but to assert that in five years the coverage would be 1.73x. Similarly, Stuy Town states an at purchase DSCR of .58x but claims it will get to 1.73x in 2011. These unrealistic debt service coverage ratios are based on wildly optimistic increases in NOI. Some examples:
    - The Savoy Park, formerly the Delano, anticipates an increase in NOI from $7.4 million to $19 million in five years, an increase of nearly 150%.
    - The Broadway Portfolio similarly estimates NOI increasing from $2.4 million to $6.1 million, or 147%.
    - Peter Cooper Village and Stuy Town report that an NOI of $112 million in 2006 will be $333 million in 2011, nearly a 200% increase in 5 years.
    - The Mayberry which had an in-place NOI of $2,483,645 projects an Underwritten NOI of $7,025,820 a 352% increase; this in a project where more than half of the units are already deregulated, and aggressive assumptions about market increases drive part of the assumed increase in NOI.
    - The Riverton projects NOI increasing in five years from $5.2 million to $23.6 million, a 349% increase.
- 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. Only the Stuy Town loan and the Mayberry loan had ten-year terms. Reliance on 100% 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. No requirements regulate reporting of sources of mezzanine loans. 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 non-performing 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 (or Gross Income Multiple) to derive estimates of current market value. In many of these loans, the Gross Income Multiple is extremely high, although some of the numbers below are estimates because income from commercial space, professional space or parking lots is not typically disclosed in the SEC filings.

    - The Broadway Portfolio, with an appraised value of $109 million has a gross income multiplier of 26;
    - The Mayberry, with 180 units and appraised at $145,000,000, where in fact an assumption about substantial parking and professional space income is included in the calculation, has a Gross Income Multiplier of 25.5;
    - The Savoy, appraised at $420 million, has a gross income multiplier of 24;
    - The Riverton, which provided two appraised values "As-Is" at securitization of $260 million with a multiplier of 19, and "As-Stabilized" in 2011 of $340 million or 25. Here the term "as-stabilized" is ironic, because it assumes the higher value when the goal is reached where 53% of the units are deregulated by 2011 and are no longer rent stabilized.

- Understating the costs of Maintaining and Operating Buildings. In some, but not all of the projects, reported or imputed operating costs bear little relation to the reality of operating multi-family rental housing in New York City.

    - For the Broadway Portfolio an at purchase NOI of $2,470,103 is stated in the FWP. Based on a non-weighted average rent of $752 derived from rents stated in the SEC filing, the gross income for the portfolios' 455 apartments (excluding commercial space because no information is provided) would be $4,105,920. This Gross Income, less the stated Vacancy of 1% or $41,059 based on a December 2006 rent roll, yields a net income of $4,064, 861. The imputed M&O including RE taxes, derived from imputed average rents less stated NOI, is $1,594, 758 or $3,505 per du/yr. When actual RE Taxes (obtained from ACRIS and the DOF) of $826,613 are deducted , annual operating expenses less RE taxes equal an impossibly low $1,688 per du/yr. Compare this to the RGB 2008 Income and Expense Survey[3]. The Broadway Portfolio contains buildings built before 1947, and most are between 20 and 99 units in size. For similar Upper Manhattan properties, annual operating costs less RE taxes are $6,744 per du/yr. The UW Expenses (M&O) is over $3,000 less per unit per year than the actual average for similar Upper Manhattan Buildings.

Reading the Default Risk Chart

Below is a chart summarizing some other characteristics and the default risks of ten major predatory equity loans that supplements SEC disclosed information with updated information provided by the loan

[3] Each year the New York City Rent Guidelines Board publishes an annual report on income and expenses. The 2008 Income and Expense Study examined information from 12,644 rent-stabilized apartment buildings across the City.

servicers to Trepp[4]. A number of indicators listed on the left hand side of the chart reveal more about key financing assumptions.

The Appraised Value, either "as-is" or "stabilized" and whether it is higher than could be justified by building income is one important indicator. As discussed earlier, the Gross Rent Multiple (GRM) is derived from dividing the appraised value by current yearly gross rental income. The resulting number is an indicator of whether the portfolio's value is in line with the historical and current market for rent stabilized multi-family buildings. While in recent years the GRM for purchase of rental properties has increased substantially because of the City's protracted real estate boom, the GRM for a number of the portfolios is near to or exceeds 20, and this is an exceptionally high figure.

Another key indicator that can be extracted from the FWP and that is shown in several places on the chart is Debt Service interest payments on a per unit and per month basis. Some of the projects were financed with a first mortgage and disclose additional mezzanine debt. This Debt, on a per unit/per month basis is compared to the average rent at purchase. Note that in a seven of the portfolios, the total interest-only monthly debt service payment exceeds at purchase average rents.

Most SEC filings disclose an average rent at purchase and a (NOI) at purchase, or provide information from which these figures can be imputed. NOI is income after all operating expenses except debt service are paid. The chart shows that in all but the Three Borough Pool and the Queens Multi-Family portfolios, the UW NOI greatly exceeds at purchase NOI.

Debt Service Coverage Ratio (DSCR) is the ratio of debt service to NOI. In many of the loans, the disclosed DSCR at purchase is well below 1:1. But UW DSCR exceeds 1:1. Those portfolio loans that have additional mezzanine financing sometimes do, and sometimes do not, disclose a DSCR that includes the mezzanine debt.

About the Data Sources: The portfolios and/or buildings described in the chart were purchased in 2006 and 2007. Because the loans were securitized, the borrower is required to report revenue, expenses, and vacancies to their loan servicer, and this information is tracked against the underwriting assumptions stated in the FWP. This information is published in an industry data service called Trepp. Access to the owners' own reports has allowed ANHD to determine whether a loan was performing and meeting its underwriting targets. Loan servicers place loans on a "watch list" if the DSCR is inadequate. The chart presents actual Occupancy (Vacancy) rates, Revenue and Expenses as reported in Trepp. The comparison of actual information to UW projections is revealing. It confirms that the aggressive underwriting assumptions used to justify inflated loans are unrealistic and in all but two loans, Revenues are lower and Expenses are higher than underwritten.

[4] The Peter Cooper Village & Stuyvesant Town Loans, while listed on the table as one loan, is actually five pari-passu loans totaling $3,000,000,000.

SECURITIZED LOANS PORTFOLIOS OF MULTI-FAMILY RENTAL NYC	Three Borough Portfolio	Queens Multi-Family Portfolio	Savoy Park	Broadway Portfolio	Esquire Portfolio
Owner	Westbrook,Normandy, Barclays, Vantage	Vantage/Apollo	Vantage/Apollo	Vantage/Apollo	Vantage/Apollo
# of Buildings	42	31	7	8	4
Residential Dus	1,646	2,124	1,802	455	214
Comm/Professional Units or SF	42	22	NA	43	7
Parking					
Location	Manhattan, Bronx and Queens	11 submarkets of Queens	Harlem	Washington Hts Manhattan	Hamilton Heights Manhattan
SERVICER info '07-'08	*Not on Watchlist*	*Not on Watchlist*	*Watchlist 04/08*	*Not on Watchlist*	*Watchlist 07/08*
SECURITIZATION INFO	WBCMT 2007-C33	CSMC 2006-C5	CSMC 2007-C1	CSMC 2007-C2	CSMC 2007-C4
Term Sheet Date	8/1/2007	12/1/2006	2/16/2007	4/13/2007	8/13/2007
Appraised"As-Is" Value in FWP	$158,400,000	$303,300,000	$420,000,000	$109,700,000	$42,100,000
"As-Stabilized" Appraised					
Appraised "As-Is"Value Per DU	$96,233	$142,797	$233,074	$241,099	$196,729
Appraised "As-Is" Gross Rent Multiple	9.32	13.05	24.37	26.72	19.54
Average Rent DU/mo at purchase	$860	$923	$797	$752	$814
Lender	Barclays Capital Real Estate	Column Financial	Column Financial	Column Financial	Column Financial
First Mortgage	$133,000,000	$192,000,000	$210,000,000	$70,000,000	$31,000,000
Interest	5.7850%	6.2543%	6.1354%	6.2396%	5.7860%
Term	5	7	7	7	7
Amortization	balloon	balloon	balloon	balloon	balloon
First Mortgage Amount Per DU	$80,802	$90,395	$116,537	$153,846	$144,860
New First Mort Debt Service Per DU/mo	$390	$471	$596	$800	$698
Mezzanie Debt	$0	$58,000,000	$157,000,000	$23,000,000	$3,170,000
# of Mezzanine Loans	None	2	4	1	1
Int / blended (or est. at 7%)		6.8144%	7.0528%	7.07%	7.00%
Assumed Term		7	7	7	not stated
Assumed Amortization		balloon	balloon	balloon	balloon
Der DU		$27,307	$87,125	$50,549	$14,813
New Mezz DS DU/month		$155	$512	$298	$86
Total Combined Debt Service per	$390	$626	$1,108	$1,098	$785
% of New DS to Rents at Purchase	45.29%	67.86%	139.02%	146.01%	96.42%
NOI At Purchase	$8,834,420	$12,700,866	$7,747,208	$2,470,103	$960,996
NCF at Purchase if Different)					
NOI AS UNDERWRITTEN	$10,480,960	$14,584,451	$19,132,596	$6,115,415	$3,423,179
Increase in NOI	18.64%	14.83%	146.96%	147.58%	256.21%
DSCR at Purchase(w/o Mezz)	1.15	1.06	0.60	0.57	0.54
DSCR at Purchase(w/ Mezz)		0.80	0.32	0.41	0.48
UW DSCR	1.29	1.20	1.46	1.36	1.85
UW Occupancy	96.31%	99.00%	97.00%		99.00%
Revenues UNDERWRITTEN	$17,970,768	$21,020,053	$28,610,163	$9,503,453	$5,074,263
EXPENSES UNDERWRITTEN	$7,489,818	$9,020,053	$9,027,067	$3,388,038	$1,651,084
SERVICER REPORTS					
NOI		$24,181,053	$4,739,199	$1,703,704	$733,218
NCF	$10,068,950	$23,653,849	$4,288,698	$1,589,953	$684,167
DSCR (NOI) Excl Mezz	No info provided	1.72	0.36	0.30	0.44
DSCR (NCF) Exclude Mezz		1.68	0.33	0.28	0.41
Occupancy		94%	95.47%	98.00%	99.00%
Revenues		$38,616,383	$17,310,476	$5,061,035	$1,931,988
Expenses		$14,435,331	$12,571,278	$3,357,332	$1,180,770
EXCEED/DO NOT EXCEED TARGET NOI		$24,181,052	($6,561,318)	($2,758,083)	($2,242,409)
Notes:	Less new debt as others and its average rent at purchase was not the lowest	Expenses much higher than underwritten, but revenues are $16 million more than UW	DSCR is worsening. Expenses are much higher than underwritten	Not sure why not on Watchlist. DSCR is getting worse	DSCR is getting worse, but expenses lss than projected

SECURITIZED LOANS PORTFOLIOS OF MULTI-FAMILY RENTAL NYC	Riverton Apartments	Manhattan Apartment Portfolio	NYC Portfolio	Mayberry	Peter Cooper Village & Stuyvesant Town
Owner	**Larry Gluck and Rockport Group**	**Pinnacle,The Praedium Group**	**Dawnay Day**	**Atlas Capital Group**	**Tishman Speyer, Blackrock**
# of Buildings	7	36	37	1	57
Residential Dus	1,230	1,083	1,142	180	11,227
Comm/Professional Units or SF	2	2	58	8	117,711
Parking				93	2,260
Location	Harlem	East Harlem	East Harlem	East 63rd Manhattan	East Manhattan, 14th - 23rd Sts
SERVICER info '07-'08	***Not on Watch list***	***Watchlist 12/07***	***Watchlist 03/08***	***Watchlist 03/08***	***Watchlist 04/08***
SECURITIZATION INFO	CD 2007-C4	GECMC 2007-C1	MSC 2007-IQ14	CSMC 2007-C4	multiple
Term Sheet Date	3/5/2007	4/12/2007	3/19/2007	6/1/2007	11/17/2006
Appraised"As-Is" Value in FWP	$260,000,000	$255,000,000	$244,000,000	$145,000,000	$5,400,000,000
"As-Stabilized" Appraised	$340,000,000		$321,199,999	$116,644,444	$6,900,000,000
Appraised "As-Is"Value Per DU	$211,382	$225,300	$213,660	$805,556	$480,983
Appraised "As-Is" Gross Rent Multiple	**19.70**	**22.14**	**18.76**	**25.53**	**23.48**
Average Rent DU/mo at purchase	**$894**	**$1,002**	**$949**	**$2,328**	**$1,707**
Lender	Capital Corporation	Capital Corporation	La Salle	Column Financial	Wachovia, Merrill Lynch
First Mortgage	$225,000,000	$204,000,000	$195,000,000	$90,000,000	$3,000,000,000
Interest	5.9986%	6.2400%	5.8000%	5.5000%	6.4340%
Term	5	5	5	10	10
Amortization	balloon	balloon	balloon	balloon	balloon
First Mortgage Amount Per DU	$182,927	$188,366	$170,753	$500,000	$267,213
New First Mort Debt Service Per DU/mo	$914	$980	$825	$2,292	$1,433
Mezzanie Debt	$25,000,000	$0	$20,000,000	$34,000,000	$1,400,000,000
# of Mezzanine Loans	`	None	1	1	11
Int / blended (or est. at 7%)	7.00%		7.00%	7.00%	7%
Assumed Term					10
Assumed Amortization	balloon		balloon	balloon	ballon
Der DU	$20,325		$17,513	$188,889	$124,699
New Mezz DS DU/month	$119		$102	$1,102	$727
Total Combined Debt Service per	**$1,033**	**$980**	**$927**	**$3,394**	**$2,160**
% of New DS to Rents at Purchase	**115.55%**	**97.75%**	**97.68%**	**145.79%**	**126.54%**
NOI At Purchase	$5,263,772	$5,415,658	$10,408,298	$2,483,645	$112,242,474
NCF at Purchase if Different)					
NOI AS UNDERWRITTEN	$24,007,857	$18,001,713	$16,515,458	$7,025,820	$333,909,980
Increase in NOI	356.10%	232.40%	58.68%	182.88%	197.49%
DSCR at Purchase(w/o Mezz)	**0.39**			**0.50**	**0.58**
DSCR at Purchase(w/ Mezz)	**0.35**	**0.42**		**0.34**	**0.39**
UW DSCR	1.73 and 1.19 w/ mezz	1.42	1.44	1.73	1.73
UW Occupancy	96.70%	96.9%		87.2%	96.9%
Revenues UNDERWRITTEN	$33,029,623	$24,490,750	$22,104,255	$9,792,911	$481,725,392
EXPENSES UNDERWRITTEN	$9,021,766	$6,489,037	$5,588,797	$2,767,091	$145,569,012
SERVICER REPORTS					
NOI	$4,192,455	$5,179,008		$3,412,482	$108,271,311
NCF	$3,846,361	$5,179,007		$3,097,396	$106,024,910
DSCR (NOI) Excl Mezz	**0.31**	**0.40**	**No info provided**	**0.68**	**0.56**
DSCR (NCF) Exclude Mezz	**0.28**	**0.40**		**0.62**	**0.55**
Occupancy	97.00%	95.00%		65.00%	94.00%
Revenues	$13,786,597	$12,232,828		$6,346,486	$248,849,924
Expenses	$9,594,142	$7,053,821		$2,934,004	$140,578,614
EXCEED/DO NOT EXCEED TARGET NOI	($14,413,715)	($10,947,892)		($4,091,816)	($193,331,366)
Notes:	Going in the wrong direction. Coverage getting worse, expenses higher than projected	Going in the wrong direction. Coverage getting worse, expenses higher than projected	FWP information is skimpy. Dawnay Day has gone under, dispo of bldgs unknown	Recent Reduction in Appraised Value. DSCR is better, but expenses higher than UW	Revenues less than UW, higher Vacancy and DSCR going down

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 investment rating agencies – Standard and Poor's, Fitch and Moody's – play a central role in creating salable 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 sub-prime crisis is now well understood. A recent, scathing report by the Securities and Exchange Commission states "The rating agencies' performance in rating these [residential sub-prime] 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".[5]

We believe that this may be as true in the commercial lending markets that we have examined as it is in the residential lending market. A prime example is the rating for the $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 the credit rating agencies Standard & Poor's and Moody's, declaring the deal "investment-grade".

In fact, an analysis of the deal suggests that it is clearly "speculative". As the analysis of Stuyvesant Town-Peter Cooper Village shows, the deal is based on unsustainable assumptions, including:

- Net Operating Income will increase by 200% within five years, although there is no clear path to achieve this remarkable increase.
- Approximately 3,000 rent regulated units will be de-regulated with five years, although the historic turnover average is only 5.6% a year, far below what is needed to recapture 3,000 apartments.
- Rents on units that are currently de-regulated will increase by 15% to 30% to bring them to "market".

None of these assumptions is realistic, even in the most optimistic market conditions, making the deal speculative and raising serious questions about the "investment grade" BBB- rating. *See the appended chart for more detail.* The rating agencies rating criteria should be called into question.

The other predatory equity deals that 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 a AAA rating. Any danger to the investor in the security is expected to be hedged by various forms of "credit enhancements" that are structured into the security pool. These credit enhancements include traunching and over-collateralization. These same types of credit enhancements were expected to shield investors from losses in residential 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 may well present a similar danger in the commercial loan market, and calls into serous question the role of the credit rating agencies.

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[5] *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.

Conclusion – What can be done to Protect Tenants, Communities and Investors?
As the residential sub-prime crisis has demonstrated, existing protections were inadequate for individuals taking out loans and investors in the investment securities backed by those loans, and the consequences have been calamitous. This paper suggests that there is a serious problem because of the scale of speculative loans on multi-family buildings. New protections must be put in place to safeguard the tenants, affordable housing, communities, and investors who may be damaged.

Intergovernmental Working Group - There is no silver bullet for the problems that collapsing predatory equity deals will cause and no one governmental agency can be responsible for the solution. However, 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. The first step must be to recognize the predatory equity buildings as a specific group of building facing a specific crisis, and to create an ad hoc, intergovernmental working group to combine resources and strategies. This intergovernmental working group should be led by the city Department of Housing Preservation and Development, and include the state Division of Housing and Community Renewal, the state Housing Finance Agency, the city housing finance agency, and the state Attorney General. Appropriate city-wide housing policy groups should also be included.

Enforce and Strengthen Tenant Protections – There are three areas where government must act:

- **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, with illegal harassment often the consequence. If our primary goal is to preserve affordable housing, then the first line of defense must be assisting tenants to understand their rights so they can stay in their homes. Anti-harassment protections for tenants, including the recently signed New York City 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. Resources must be committed so that community groups can, working with their political representatives, pro-actively reach out to buildings and educate tenants to protect their rights in buildings targeted by a predatory equity investment strategy.
- **Stop Fraudulent Abuse in the Apartment Improvement Rent Increase System.** 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. Unfortunately, the 1/40th program is often subject to fraud because it relies on landlord self-certification. In fact, the state agency that oversees the rent regulation system, the Division of Housing and Community Renewal (DHCR), does not require landlords to provide any proof of the cost of the improvement on which the rent increased was based unless a tenant first files a challenge. This leaves tenants vulnerable, and the rules virtually un-enforced. The DHCR must administer the 1/40th program more effectively by setting a trigger mechanism – such as an increase of 25% of the base rent - that would require a landlord to provide proof of the cost of any improvement before a rent increase is allowed.
- **Target Code Enforcement in Affected Buildings.** As buildings with a predatory equity investment strategy begin to face 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. The New York City Department of Housing Preservation and Development (HPD) must commit code enforcement resources, including inspections, litigation, and emergency repair, to help avoid building deterioration. HPD should proactively target these buildings before the crisis becomes severe.

Find a Preservation Purchaser for Buildings that Default – Many of the multi-family buildings bought by predatory equity developers will fall into foreclosure or other forms of 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. These distressed projects in turn depress the block in which they are located, and the neighborhoods in which they are concentrated. City and state authorities must develop a plan and commit resources to protect this hard-to-replace affordable housing. To use the finance industries term, there must be an "orderly de-leveraging" of these assets by finding a preservation purchaser for defaulting building. A series of issues present themselves, which must be considered by the ad hoc intergovernmental working group that we recommend above.

- When a landlord defaults on a loan, the lender may try to recoup maximum value for that loan by selling it to a new buyer, who becomes the new landlord. But, if the loan is unsustainable from its inception, a new buyer will just continue the existing problems. This means that the lender must sell the loan at a highly discounted rate to a preservation purchaser. The government must deploy creative strategies in order to have the leverage to ensure this outcome.
- If the landlord defaults on the first loan, they may well have defaulted on the subordinate mezzanine debt that is layered into many of these predatory equity deals. The mezzanine lender may have a legal claim on the ownership entity.
- In deals where the first loan has been packaged into a mortgage-backed security, it is unclear who owns the loan, and who has authority renegotiate, sell, or foreclose on a non-performing loan. Parties include the security pool underwriter, servicer, master servicer, and special servicer, all of whom may claim to have the right to act in the interests of the security pool investors. These issues may have to be worked out in court in each case, and may create a timeline that brings the building to the foreshortened process of bankruptcy court instead of a foreclosure hearing.
- These deals were grossly overpriced and over-financed from their inception, and it may be expensive to provide preservation financing for even a discounted loan.

In spite of the complexities, it is always more cost-effective to preserve existing affordable housing then it is to build it new, and the ad hoc intergovernmental working group must develop the strategy and resources to find and finance preservation purchasers for this at-risk housing.

Legal Enforcement – The state Attorney General has the authority to investigate predatory equity developers, lenders, and security pool underwriters. Where a violation of the law is found, there may be standing under various investor protection, consumer protection, and civil rights protection statutes to bring a prosecution.

Although the above solutions are targeted a city and state government, it may also be necessary to increase oversight and regulation at a federal level to stop the excesses of predatory equity.

New Guidelines for Lenders – New guidelines must be developed to require that lending on rent regulated multi-family properties be based on realistic underwriting assumptions. State law specifically regulates residential lending on single-family homes. The new anti-predatory lending law recently signed by New York Governor Patterson sets a strict definition for a predatory loan and requires that lender

clearly demonstrate that the borrower has the ability to repay the loan. Because commercial loans are assumed to take place among sophisticated entities, not mom-and-pop home buyers, commercial loans are largely unregulated. However, as we have seen, predatory equity loans are actually residential loans, and mom-and-pop tenants are victimized as much as they are in the residential loan sub-prime crisis. Limited regulation must be created that requires commercial loans on residential properties to be based on responsible underwriting assumptions that do not lead to the victimization of tenants.

Oversee Credit Rating Agencies – New oversight must be developed for the credit rating agencies, this new oversight can include more explicit standards promulgated by the SEC, or legal action by state law enforcement authorities such as the attorney general to hold the credit rating agencies accountable.

Appendix A – Securitized Loans, Loan Pools, and Underwriter

Project	Owner	CMBS	Loan Seller	Underwriters	Securitization Date	Amount	Int	Term	Servicer Watchlist?
Three Borough Portfolio	Westbrook, Normandy, Barclays, Vantage, David Kramer	WBCMT 2007-C33	Barclays Capital Real Estate	Wachovia Barclays Cap RE, Noruma, Artesia	June, 2007	$133,000,000	5.785%	5	No
Queens Multifamily	Vantage/Apollo	CSMC2006- C5	Column Financial	Credit Suisse, Citigroup, KeyBanc, RBS Greenwich Cap, Banc of Amer Securities	December, 2006	$192,000,000	6.354%	7	No
Savoy Park	Vantage/Apollo	CSMC 2007-C1	Column Financial	Credit Suisse, Capmark Securities, CA Fina Group, Greenwich Cap Mkts, Wachovia	February, 2007	$210,000,000	6.135%	7	Yes 04/2008
Broadway Portfolio	Vantage/Apollo	CSMC 2007-C2	Column Financial	Credit Suisse, CA Fina Group, KeyBanc Cap Mkts,Greenwich Cap Mkts, Wachovia	April, 2007	$70,000,000	6.239%	7	No But not performing
Esquire Portfolio	Vantage/Apollo	CSMC-2007-C4	Column Financial	Credit Suisse First Boston Mortgage Sec, Greenwich Cap Mkts, PNC Capital Mkts	August, 2007	$31,000,000	5.786%	7	Yes 07/2008

Project	Owner	CMBS	Loan Seller	Underwriters	Securitization Date	Amount	Int	Term	Servicer Watchlist ?
Riverton Apartments	Rock Point/ Stellar	CD 2007 – C4	German American Cap Corp	Citigroup Global Mkts, German Amer Cap Corp, La Salle, PNC Bank, Royal Bank of Canada	January, 2007	$225,000,000	5.998%	5	No But reports of default
Manhattan Apartment Portfolio	Pinnacle, Joel Weiner The Praedium Group	GECMC 2007-C1	German American Cap Corp	GE Cap Corp, German American Bank of America, Barclays Cap RE	June, 2007	$204,000,000	6.240%	5	Yes 12/2007
NYC Portfolio Roll Up Dawnay Day	Dawnay Day	MSC-2007 IQI4	La Salle	La Salle, Morgan Stanley, Principal Comm. Fund II, Royal Bank of Canada, Prudential Mort. Cap, Wells Fargo	May, 2007	$195,000,000	5.8%	5	Yes 03/2008
Meyberry	Atlas Cap Grp J. Goldberger & A.Cohen	CSMC 2007-C4	Column Financial	Credit Suisse Greenwich Cap PNC Cap Mkts.	June, 2007	$90,000,000	5.5%	10	Yes 03/2008

Project	**Owner**	**CMBS**	**Loan Seller**	**Underwriters**	**Securitization Date**	**Amount**	**Int**	**Term**	**Servicer Watchlist ?**
Peter Cooper Village & Stuyvesant Town	Tishman Speyer Blackrock Realty	Wachovia 2007-30	Wachovia	Wachovia Cap, Credit Suisse Goldman, Sachs Merrill Lynch, Pierce, Fenner & Smith Inc.	December, 2006	$1,500,000,000	6.434 %	10	Yes 04/2008
" "	" "	Wachovia 2007-C31	Wachovia	Wachovia CMBS Wachovia Bank, Nomura Credit & Capital, Inc. Barclays Capital RE	" "	$247,727,273	6.434 %	10	Yes 04/2008
" "	" "	COBALT 2007-C2	Wachovia	CW Capital LLC Wachovia Bank, Citigroup Global Artesia Mortgage Cap. Corp., Deutsche Bk Sec.	" "	$250.000,000	6.434 %	10	Yes 04/2008
" "	" "	Merrill Lynch CFC 2007-5	Merrill Lynch Mortgage Lending	Merrill Lynch, Pierce, Fenner & Smith Inc. Countrywide, IXIS Sec NA, Bear, Stearns. KeyBanc, Banc of America	" "	$800,000,000	6.384 %	10	Yes 04/2008
" "	" "	Merrill Lynch CFC 2007-6 CIK:1391668	Merrill Lynch Mortgage Lending	Merrill Lynch, Pierce, Fenner & Smith Inc. Countrywide, Credit Suisse Morgan Stanley	" "	$202,272,721	6.434 %	10	Yes 04/2008