

CAN NEW YORK AFFORD THE LOSS OF 4,000 AFFORDABLE APARTMENTS EACH YEAR?

Policy Report

CLOSING THE DOOR 2008: Subsidized Housing Losses in a Weakened Market

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By Tom Waters & Victor Bach



Ozier Muhammad/The New York Times/Redux

The Community Service Society of New York (CSS) is an informed, independent, and unwavering voice for positive action that serves the needs of our constituents: the 2 in 5 New Yorkers who live on poverty's front line. CSS draws on a 160-year history of excellence in using research, advocacy, litigation, and innovative program models to shape actionable policy solutions that strengthen and benefit all New Yorkers.

David R. Jones, President & CEO

Steven L. Krause, Executive Vice President & COO

Tom Waters is Housing Policy Analyst at the Community Service Society. Prior to joining CSS, Mr. Waters was organizer, editor, development director, and interim executive director at New York State Tenants & Neighbors, an organization that works to preserve and improve the state's existing stock of affordable housing.

Victor Bach has been senior housing policy analyst at CSS since 1983. He was a Research Associate at the Brookings Institution and on the faculty of the New School for Social Research and the LBJ School of Public Affairs.

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This report could not have been prepared without the invaluable assistance of the Legal Aid Society, the Mitchell-Lama Residents Coalition, New York State Tenants & Neighbors, Pratt Area Community Council, South Brooklyn Legal Services, the Urban Homesteading Assistance Board, and many other organizations that represent or assist low-income tenants and communities. Their activities in affordable housing preservation have given them access to much information and insight, which we have drawn on freely in framing and conducting our analysis.

New York City’s supply of subsidized, privately owned rental housing continued to erode at a very past pace in 2007, but there were significant changes in the pattern of loss compared to the previous three years, reflecting the great increase in the difficulty of obtaining credit for all kinds of investment since the middle of last year.

This affordable housing stock provides important protections from the effects of a chronic housing shortage on low-income tenants who would be unable to afford adequate housing in the unassisted rental market. Unfortunately, the subsidized housing stock has dwindled rapidly, especially since 1997. Two previous reports by the Community Service Society have interpreted the losses as partly due to the physical deterioration of part of the stock and partly due to the opportunities for owners to receive larger profits in the unsubsidized market.¹

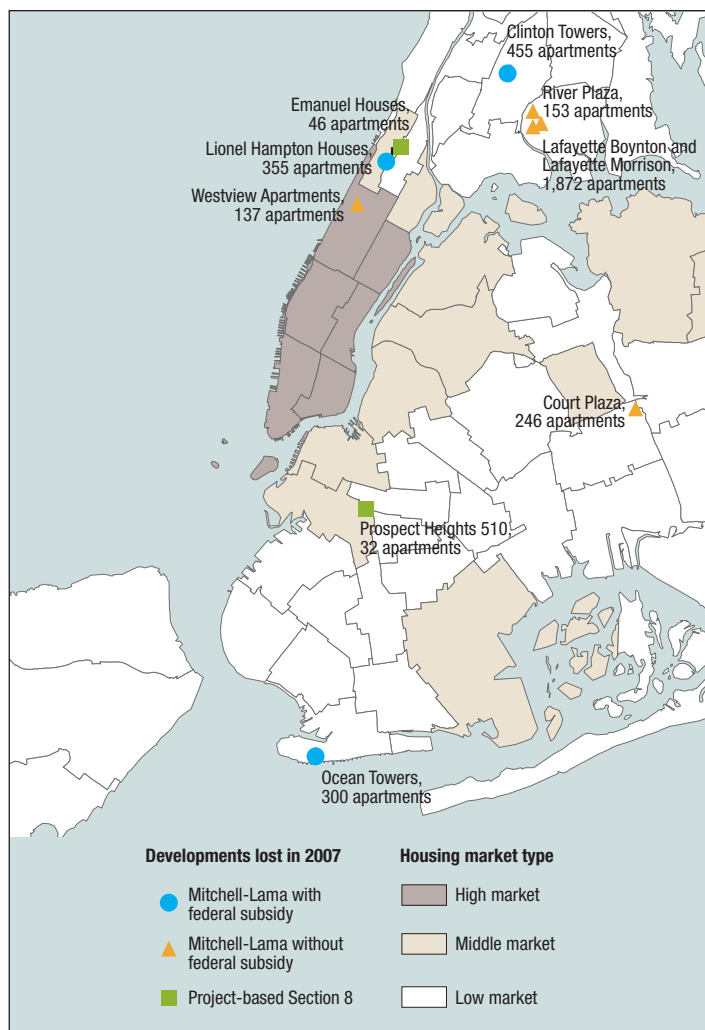
This paper updates the analysis of the crisis in subsidized housing contained in our previous papers, and it considers the factors that will influence whether the erosion of this stock will slow, or whether we will continue to experience the fast pace of loss seen since 2004. It covers the major subsidy programs that developed rental housing for low-income families through the early 1980s – the federal mortgage subsidy programs, the federal rent subsidy programs including project-based Section 8, the city and state Mitchell-Lama rental programs, and the pre-Mitchell-Lama limited dividend rental program. But it does not include the Low Income Housing Tax Credit or tax-exempt bond programs or the Section 202 and Section 811 programs targeted to seniors and people with disabilities. Nor does it include Section 8 vouchers.

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Subsidized housing and the credit crisis: an update

As of the end of 2007, 30 percent of the city’s 119,061 apartments in these subsidy programs had been lost since 1990, and another 19 percent face an active threat of subsidy loss.

Map 1
Subsidized developments lost in 2007



Mitchell-Lama rentals have been hit hardest, losing 29,831 units, 45 percent of those that existed in 1990. During calendar 2007, 3,656 units were lost, or 4 percent of the stock that remained at the beginning of the year. Almost all – 3,578 of those units – were Mitchell-Lama rentals. That was only slightly less than in the period from 2004 to 2006, when annual losses averaged over 4,000 per year.

Also in 2007, 78 non-Mitchell-Lama units were lost in two small project-based Section 8 buildings. This was an improvement over 2006, when 421 units were lost – 335 due to enforcement actions taken by the federal Department of Housing and Urban Development (HUD) and 86 in buildings where owners “opted out” of the Section 8 program voluntarily. In 2007, both of the lost buildings opted out voluntarily.

after being in the process of opting out for some time. Neither faced any enforcement action or other obvious causes for leaving the program.

All of the 2007 losses were located in low-market areas of the city, except for one Mitchell-Lama development in Manhattan.² By far the worst losses were in the Bronx, continuing the pattern seen in 2006. Tables 2 and 3 and Map 1 summarize the year’s losses.

But these numbers do not tell the whole story. The 2007 losses of subsidized housing were overwhelmingly concentrated in the first half of the year. This pattern appears to be the effect of the credit crisis that began in August 2007 as securities backed by single-family mortgages began to unravel, making it much more difficult to arrange financing for any large transaction. During the first six months of the year, when credit was more freely available, six Mitchell-Lama rental apartment buildings with a total of 3,195 apartments were removed from the subsidy program. Another building with 246 units was removed in August, as the credit crisis was just beginning. Buy-outs, in other words, were proceeding at an even higher rate than in previous years. But once the crisis was fully underway, only one Mitchell-Lama

building, with 137 units, was lost, and that was a case that did not involve a transfer of ownership and therefore required less than \$3 million to replace a subsidized mortgage.

Trends in the residential investment property market

Does this pattern indicate the removal of the real estate market forces that underlay the trend toward buy-outs in recent years: rising rents, the consequent increase in potential profits in the unsubsidized market, and the willingness of investors to bet that the market would continue to rise? Or is the credit crisis merely holding back buy-outs by making them more difficult to finance, concealing the continued presence of the forces driving the loss of subsidized housing?

An analysis of the New York City Department of Finance information on property transactions shows that while the pace of real estate investment has declined in recent years, the prices at which rental apartment buildings change hands in Upper Manhattan and the outer boroughs has not. This is consistent with the idea that it has gotten more difficult to put a real estate deal together, but that owning rental apartment buildings has not become a less good investment. From July 2004

Table 1 Losses of affordable housing by category					
	Apartments in 1990	Apartments in 2006	Apartments in 2007	Lost, 1990-2007	Lost, 2006-2007
Mitchell-Lama					
With federal subsidy	41,822	30,080	28,910	12,912 (31 %)	1,170 (4 %)
Without federal subsidy	23,823	9,312	6,904	16,919 (71 %)	2,408 (26 %)
Total Mitchell-Lama	65,645	39,392	35,814	29,831 (45 %)	3,578 (9 %)
Not Mitchell-Lama					
Project-based Section 8	52,578	46,579	46,501	6,077 (12 %)	78 (< 1 %)
Other federal subsidy	838	582	582	256 (31 %)	0
Total not Mitchell-Lama	53,416	47,161	47,083	6,333 (12 %)	78 (< 1 %)
TOTAL	119,061	86,553	82,897	36,164 (30 %)	3,656 (4 %)

Source: Data compiled by the Community Service Society from records of the U.S. Department of Housing and Urban Development, New York State Division of Housing and Community Renewal, New York City Department of Housing Preservation and Development, and Office of the Comptroller of the City of New York.

to June 2005, about 65,000 rental apartments in buildings of at least four units changed hands at non-zero prices. In each of the next two 12-month periods, about 75,000 apartments were sold. But from July 2007 to June 2008, the number dropped to about 50,000. Tellingly, sales of buildings with more than 160 units rose and fell even more dramatically than sales of smaller buildings. In the July 2004–June 2005 period, about 8,000 rental apartments changed hands. By the 2006-2007 period, that figure had risen to more than 21,000 apartments. But in the 2007-2008 period, it was back to about 8,000. Mitchell-Lama rental apartment buildings typically have well over 160 apartments. Figure 1 shows that the fall-off since the credit crisis began in summer 2007 has affected the entire city.³

But the behavior of the market prices was quite different in different parts of the city during the same period. In Manhattan below Harlem, prices reached a dramatic peak during the period from July 2006 to June 2007, immediately prior to the crisis, and then fell back. But as Figure 2 shows, in every other part of the city, prices actually rose from the 2006-2007 period to the 2007-2008 one.⁴ (Prices in all boroughs had climbed steadily from 1996 to 2004.⁵)

In July 2008 the real estate trade publication *The Real Deal* reported an interesting trend that could also have some bearing on the post-credit crisis decline in Mitchell-Lama buy-outs. The paper reported that sellers of large portfolios of apartment buildings have been breaking them into smaller portfolios in order to make the deals easier to finance, while still receiving high prices for them.⁶ This is also consonant with the idea that access to capital is slowing sales, rather

than a perception that the value of New York City rental properties has diminished.

There are several more reasons to be concerned that the real estate market conditions that drove the buy-outs will persist. One is the continued interest in New York City real estate by foreign investors. In July, for example, the Associated Press reported that Middle East investors were pulling back from United States real estate – but were concentrating their remaining investments in New York City.⁷ Another is the continued interest in residential real estate in the city’s working-class neighborhoods by investors backed by private equity firms. Investors of this type were a new addition to the low- and moderate-income housing picture during the peak years of the real estate boom and Mitchell-Lama buy-out wave, and they have not at all disappeared from the scene since the credit crisis. See the further discussion below of “predatory equity,” as tenant advocates call the phenomenon.

In short, it appears that market conditions are still ripe for Mitchell-Lama buy-outs and the major obstacle preventing them from happening is credit availability. Once credit institutions recover and reenter the market, the threat of a new avalanche of buy-outs is a major concern. It remains imperative for local, state, and federal governments to develop a coherent policy response to this threat.

Market threats and distress threats

Another way to assess the danger to the affordable housing stock is to consider the large number of apartments that are still in the subsidy programs, but face immediate threats to their continued affordability. New York City’s subsidized housing faces two distinct threats today. The first threat is the one underlying the recent losses of Mitchell-Lama housing – the

Table 2
Losses of affordable housing in 2007 by borough and category

	Mitchell-Lama federal	Mitchell-Lama non-federal	Non-Mitchell-Lama Section 8	Total
Bronx	455	2,025	0	2,480
Brooklyn	360	0	32	392
Manhattan	355	137	46	538
Queens	0	246	0	246
Staten Island	0	0	0	0
TOTAL	1,170	2,408	78	3,656

Table 3
Losses of affordable housing in 2007 by market type and category

	Mitchell-Lama federal	Mitchell-Lama non-federal	Non-Mitchell-Lama Section 8	Total
Low market	1,170	2,271	78	3,519
Middle market	0	0	0	0
High market	0	137	0	137
TOTAL	1,170	2,408	78	3,656

danger that a building will be voluntarily removed from the subsidy program by its owner, seeking higher profits in the open market, which we term the “market threat.” The second threat is the danger that negligent management will lead to poor building conditions, disqualifying the development from its subsidy programs, which we term the “distress threat.”

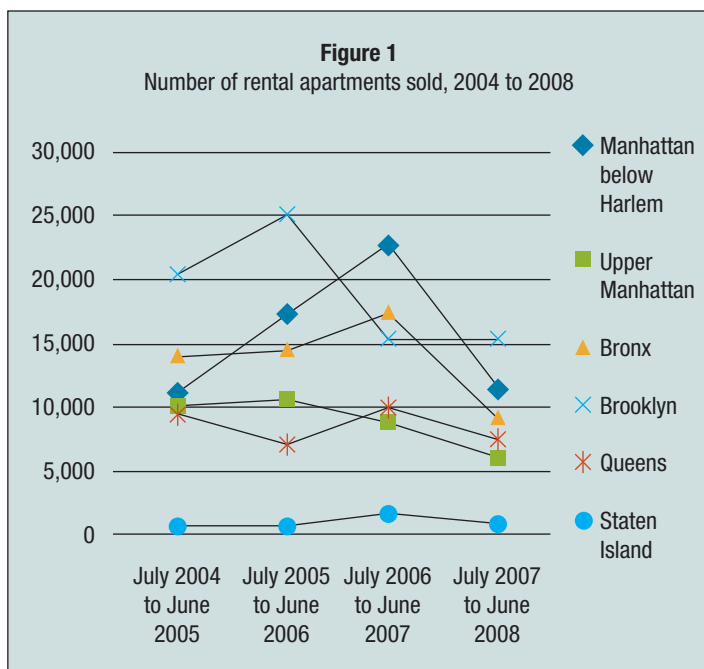
“Once credit institutions recover and reenter the market, the threat of a new avalanche of buy-outs is a major concern.”

Although the market threat is most pronounced in areas where market rents are high, and the distress threat where market rents are low, the fact is that both threats can affect the same neighborhood or even the same development.

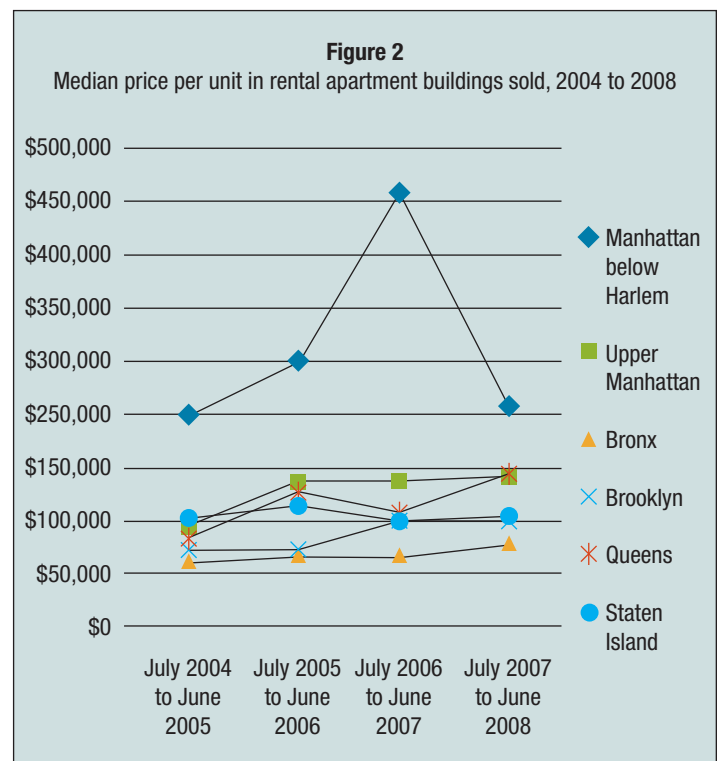
Large portions of New York City’s subsidized stock do continue to face these threats. The number of Mitchell-Lama apartments facing market threats today has decreased considerably from a year ago, but is nevertheless quite high: 3,242 apartments (9 percent of the Mitchell-Lama rental stock), compared

to more than 6,768 at the end of 2006. The decrease reflects the fact that only three buildings included in this study, with 813 apartments, received new buy-out notices in 2007, while a total of 3,578 apartments were lost, and two buildings with 761 apartments have received a sort of reprieve. (This reprieve came when the state Division of Housing and Community Renewal ruled that no more Mitchell-Lamas on Roosevelt Island could leave the subsidy program under the terms of the ground lease covering all of the island’s housing developments.) Thus, it appears that the slowdown in the city’s housing market may well have affected buy-out notices as well as actual buy-outs (which must be given one year in advance).

Note, however, that the market threat to the project-based Section 8 stock is difficult to estimate. During the period from 1990 to the present, few project-based Section 8 apartments have been lost due solely to market forces. Most losses, on the contrary, have been in the city’s lowest-market areas, where distressed physical conditions or financial distress may have played a role. Section 8 landlords commonly give notice that they intend to opt out of the subsidy program when their sub-



Source: Data on property sales downloaded from the New York City Department of Finance web site.



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sidy contracts are set to expire, but this usually indicates only that they want to obtain an increased rent subsidy from the federal Department of Housing and Urban Development upon renewal of the contract. Thus, opt-out notices are not a good indicator of market threat for this category of building.

This year, however, there is indirect evidence that this pattern could change. Several project-based Section 8 buildings in Harlem have been sold to Tahl-Propp, a private-equity backed real estate group that has no history of investing in subsidized housing, but does have a clear business plan of developing market-rate luxury housing in Harlem.

The distress threat continues to be a major factor for both Mitchell-Lama and project-based Section 8 housing. No apartments were lost in 2007 due to distressed conditions, but that is a tribute to the success of tenant organizers, nonprofit developers, and the New York City Department of Housing Preservation and Development (HUD) in preventing losses, rather than a sign that the threat is weak.

	Apartments remaining	Market threat	Distress threat	Both threats
Mitchell-Lama and Limited Dividend				
With federal subsidy	28,910	2,561 (9 %)	6,165 (21 %)	580 (2 %)
Without federal subsidy	6,904	101 (3 %)	Not defined	Not defined
Total Mitchell-Lama	35,814	2,662 (7 %)	6,165 (17 %)	580 (2 %)
Not Mitchell-Lama				
Project-based Section 8	46,501	Not Defined	7,120 (15 %)	Not defined
Other federal subsidy	582	Not Defined	0	Not defined
Total not Mitchell-Lama	47,083	Not Defined	7,120 (15 %)	Not defined
TOTAL	82,897	2,662	13,285	580

Source: Estimates of threatened stock are based on information from Mitchell-Lama Residents Coalition, New York State Tenants & Neighbors Coalition, and Urban Homesteading Assistance Board.

After Pueblo de Mayagüez, a project-based Section 8 building in the Bronx, was foreclosed and auctioned by HUD in 2003, several nonprofit organizations formed the Partnership to Preserve Affordable Housing⁸ and began working closely with HPD to try to ensure that physically distressed HUD housing would be preserved as affordable. The partnership pursued a strategy of organizing tenants to press HUD to control the foreclosure process in order to transfer the buildings to nonprofit developers selected by the tenants themselves. Since that time, 19 distressed Section 8 developments, with thousands of apartments, have been transferred through HUD’s foreclosure process or other means to tenant-endorsed nonprofit developers, who are committed to rehabilitating this housing stock and to ensuring that these units remain affordable in perpetuity.

No more buildings since Pueblo de Mayagüez have been entirely lost as affordable housing through HUD foreclosure, but some buildings were lost to the Section 8 stock through 2006, because HUD did not always continue the Section 8 contract after a foreclosure. But thanks to legislation passed through the efforts of Senator Charles Schumer, HUD is now obliged to renew the contract after most foreclosures. Thus, when HUD foreclosed on Siloam House in Brooklyn and Hunts Point Rehab Phase I in the Bronx and transferred them to new nonprofit owners in 2007, the project-based Section 8 subsidies were preserved, unlike the 2006 cases of Ennis Francis House

	Apartments remaining	Market threat	Distress threat	Both threats
Bronx	25,013	1,196 (5 %)	5,733 (23 %)	0
Brooklyn	24,586	302 (1 %)	5,087 (21 %)	0
Manhattan	23,793	578 (2 %)	1,859 (8 %)	580 (2 %)
Queens	5,996	132 (2 %)	606 (10 %)	0
Staten Island	3,509	454 (13 %)	0	0
TOTAL	82,897	2,662	13,285	580

in Manhattan and Gates-Patchen Houses in Brooklyn, when the project-based subsidies lapsed and were replaced by Section 8 vouchers. Also in 2007, several distressed HUD properties, including Remeeder Houses in Brooklyn, were transferred to preservation owners without actual foreclosures.

Unfortunately, however, the number of apartments in buildings with failing scores from the federal Real Estate Assessment Center (REAC) inspection increased considerably. For the 11,251 apartments in federally subsidized buildings facing a distress threat at the beginning of the year, 78 percent are still threatened at the end of the year, and 21 percent received a passing REAC score and are no longer categorized as threatened. Meanwhile, formerly passing buildings with another 4,960 apartments failed their inspections. There are also now two Mitchell-Lama buildings in East Harlem (Lakeview Apartments and UPACA Site 7) that simultaneously face both market and distress threats – a sign of the times in that gentrifying neighborhood.

There is much more work to be done to prevent the loss of subsidized housing due to poor building conditions. It is an encouraging sign that HPD has recently formed an Interagency

Working Group and taken other valuable steps to create a more systematic response to the distress threat.

The distress threat in New York City and nationally

In late 2007, it became possible to take a more comprehensive look at the distress threat to subsidized housing when HUD released to the public a database containing REAC scores for a wide range of subsidized developments around the country. This made it possible for the first time to conduct a national analysis of the physical condition of the subsidized housing stock, and to compare buildings in the subsidy programs considered here with buildings in other subsidy programs.

The pattern that emerges underscores the severity of the distress threat facing federally subsidized housing for low-income families in New York.⁹ The national median REAC score was 90, and the national failure rate was 6 percent, but there was a very large variation by state. Among states with at least 100 properties inspected, the median score ranged from 81 to 94, and the failure rate ranged from zero to 12 percent. It was New York State that set the mark for the worst failure rate. In New York City, the failure rate was even worse, at 17 percent. Table 6 presents the figures for the ten states with the greatest numbers of buildings inspected.

One possible explanation for this pattern is that New York City has retained a large number of older subsidized housing developments in poorer condition that might have been removed from the subsidized stock in other areas. But whatever the reason for the pattern, it demonstrates that the city has a greater than usual need for policies and programs to respond to troubled subsidized housing developments.

Within New York City, inspection scores for Mitchell-Lama and project-based Section 8 buildings were very strongly correlated with the buildings’ location and with the amount of subsidy that the buildings received. But because these two factors are themselves so closely related to each other, it is difficult to disentangle one from the other. Buildings with smaller subsidies and buildings in low-market areas tend to have lower median scores and higher failure rates, but it is not clear whether which factor, rent level or geography, is the driving factor. Perhaps they both play a role.

	Median score	Failure Rate	Buildings inspected
California	85	11 %	1,566
Florida	91	6 %	636
Illinois	91	4 %	721
Massachusetts	90	5 %	725
Michigan	90	6 %	639
North Carolina	93	2 %	798
New York	87	12 %	1,255
Ohio	89	6 %	1,075
Pennsylvania	89	6 %	811
Texas	90	9 %	729
New York City	82	17 %	537
New York, not NYC	89	7 %	718
UNITED STATES	90	6 %	20,090

In project-based Section 8 buildings and many federally subsidized Mitchell-Lamas, the amount of subsidy is determined by the building’s contract rent, which is the total amount of money that HUD guarantees a landlord will receive, including the tenant’s rent payment and the subsidy. Tenants pay 30 percent of their adjusted income as rent, and HUD makes up the difference between that amount and the contract rent. Subsidized buildings in high-market areas tend to have contract rents well above the HUD Fair Market Rent (FMR), while those in low-market areas have the lowest rents. In 2007, the FMR for all of New York City was set at \$1,189 for a two-bedroom apartment. Thus a building with a contract rent at 100 percent of the FMR would receive a subsidy of \$1,189 a month for each two-bedroom apartment, minus the tenant’s share. The median tenant, with an income of about \$12,000 a year, can afford \$300 a month, leaving a typical subsidy amount of \$889 a month for that apartment.

In some Mitchell-Lama buildings, the subsidy is not based on contract rent. These buildings generally receive much less subsidy than the others, but they also tend to have higher-income tenants, so the buildings are not necessarily strapped for cash.

Most buildings in low-market areas have contract rents at or below the Fair Market Rent, most buildings in middle-market areas have contract rents from 100 to 140 percent of the Fair Market Rent, and most buildings in high-market areas have contract rents above 140 percent of the Fair Market Rent.

As Tables 7 and 8 show, buildings in high-market areas and those with high contract rents are in far superior condition to those in low- and middle-market areas and with contract rents below 140 percent of FMR. It is difficult to say whether this pattern indicates that buildings fall into poor condition when they receive inadequate subsidies or that they do so when they

	Median score	Failure rate	Buildings inspected
High market	93	0 %	39
Middle market	82	20 %	60
Low market	81	24 %	284
Total	82	21 %	383

are located in low-income, low-rent areas. But either way, it would clearly be prudent to target buildings in low-market areas and buildings with low contract rents for special attention with respect to improving building conditions. And it is also clear that the problem of inadequate maintenance of subsidized housing is primarily affecting the city’s lower-market areas.

Predatory equity

Over the past several years, a new type of real estate investor has dramatically changed the market for investments in rental housing for low- to moderate-income New Yorkers, in rent-stabilized as well as subsidized housing. Backed by capital raised on the world’s most competitive markets, these investors have a high tolerance for risk and a willingness to wait years before seeing positive returns. As a result they are prepared to pay unprecedented prices for apartment buildings, outbidding not only the landlords who have historically specialized in this housing stock but also nonprofit developers interested in preserving affordability, even when the latter have access to substantial subsidies. Housing advocates label this type of investor “predatory equity” because private equity firms play a prominent role in financing these deals and because of certain similarities with predatory lenders in the subprime single-family mortgage market: lax underwriting standards, a willingness to speculate on future price increases, a reliance on securitized debt, and indifference to the social fallout for tenants and neighborhoods.

Private equity firms describe their business as identifying undervalued, underutilized, or underperforming assets, buying them and unlocking their potential, then selling them at the improved value. From this point of view, subsidized housing occupied by

	Median score	Failure rate	Buildings inspected
Contract rent at 100 % of FMR or below	77	29 %	186
Contract rent from 100 % to 140 % of FMR	84	17 %	132
Contract rent above 140 % of FMR	86	0 %	43
Subsidy not based on contract rent	89	14 %	22
Total	82	21 %	383

low- and middle-income people could be considered “underperforming” if the net revenue, including subsidy, is less than what would be generated by a market-rate building occupied by the highest-income people willing to move to the site. As the high market conditions created by New York’s chronic housing shortage outstrip the subsidies in Mitchell-Lama buildings, this has become increasingly the case. Rent-stabilized housing, too, appears to be “underperforming” to investors who increasingly regard rent regulation as something that can be circumvented by moving aggressively to turn over the tenant population and take advantage of provisions in the law that allow large rent increases and deregulation on vacancy. The conversion of affordable housing to market housing fits comfortably within the private equity model.

“Tenant advocates have identified more than 50,000 apartments belonging to predatory equity investors. The real estate slowdown since the credit crisis in mid-2007 has not caused these investors to retreat.”

Predatory equity has played a prominent role in the Mitchell-Lama buy-out wave since 2004, when Larry Gluck bought Independence Plaza in Manhattan and removed it from the subsidy program. During the period from 2000 to 2004, most Mitchell-Lama buy-outs were undertaken by the original owners. But from 2005 to 2007, 28 of 35 buy-outs were accompanied by a sale, including 15 more sales to Gluck, as well as sales to Mark Karasick, Cammeby’s International, and the Witkoff Group – all investors active on the national and international level with access to private equity and other financial backing from Wall Street. In most cases, the Mitchell-Lama buy-out and the transfer of control occurred in the same closing.

During the same period, predatory equity buyers became prominent in the city’s rent-stabilized stock, even in unglamorous locations. The Pinnacle Group’s massive 2005 purchase of 104 buildings from notorious slumlord Baruch Singer marks the transition from the old school to the new school of rent-stabilized landlord. In 2005, Larry Gluck also purchased the Riverton Apartments in Harlem, and Stephen Siegel’s SG2

began buying rent-stabilized buildings in the Bronx, paying around \$100,000 each for apartments with rents in \$700 to \$800 a month range. Tenant advocates have identified more than 50,000 apartments belonging to predatory equity investors. The real estate slowdown since the credit crisis in mid-2007 has not caused these investors to retreat. Gluck and Karasick are still trying to purchase and buy out Mitchell-Lama apartment buildings, and Neal Rubler’s Vantage Properties is still acquiring large portfolios of rent-stabilized buildings.

Not every deal is based on the same strategy. In some cases, the strategy is to rapidly turn over the tenants in a building, replacing them with higher-income tenants capable of paying rents of \$2,000 or more. For rent-stabilized buildings, including former Mitchell-Lama rentals, this has the effect of permanently deregulating the rent. This is the strategy expressly outlined in the SEC filing related to Gluck’s 2006 refinancing of the Riverton. This refinancing included credit reserves to allow the building to lose money for several years while apartments turn over. The filing projects that half of the apartments will turn over in a five-year period, and that the new tenants will pay deregulated rents, allowing the building to eventually go into the black. But in August 2008, Gluck told the mortgage servicer for Riverton that he had made minimal progress turning over apartments, indicating that he was likely to default on the loan.

In a filing related to the purchase of a group of Washington Heights buildings subject to rent stabilization, Vantage Properties and Apollo Realty go even further, proposing to turn over 20 to 30 percent of tenants in one year. This kind of effort to increase turnover creates a motive for harassment, and tenants have charged Vantage with misusing the housing court system in order to displace them.

Similar thinking seems to lay behind the \$233,000-a-unit price that Urban American Management and the City Investment Fund paid in 2007 for 3333 Broadway, a 1,100 unit former Mitchell-Lama building in West Harlem that Cammeby’s International had purchased and bought out two years earlier. The building is not subject to rent stabilization, but many of the Mitchell-Lama tenants received enhanced Section 8 vouchers at buy-out, enabling the landlord to collect market rents. Landlords are required to accept enhanced vouchers as long as the tenants continue to qualify for them. The enormous debt service related to this purchase means that the building is

almost certainly now losing money, despite the large increase in revenue made possible by the enhanced voucher subsidy. Investors must believe that rising rents and values in West Harlem – directly adjacent to the site of Columbia University’s planned expansion – will eventually enable them to recoup both their initial investment and their operating losses.

Table 9 shows an estimate of how the finances of 3333 Broadway shifted from 2003, when it was still in the Mitchell-Lama program, to 2008, two years after Urban American and City Investment Fund bought it.¹⁰ Income from rent actually paid by tenants has risen, as some of the original Mitchell-Lama tenants were replaced by market-rate tenants, but the major boost in income has come from the enormous increase in subsidy when the original Mitchell-Lama subsidy was replaced by the enhanced vouchers. This increase is only partly compensated by the increase in tax equivalent payments. (The building is exempt from normal property tax because it sits on land owned by the quasi-public Educational Construction Fund.) But the nearly \$6 million increase in annual net subsidy is not enough to support the multi-million dollar increase in debt service due to the high price paid for the building. The negative annual net cash flow only makes sense if the investors believe that they will realize even bigger profits in the future, through higher rents or conversion to a coop or condominium.

Not every building purchased by predatory equity investors is located in a neighborhood where an optimistic investor might expect the market to lift rents above \$2,000 a month any time soon. Many buildings in fact are located in Bronx neighborhoods far from the front lines of gentrification. In these areas, prices and financing for rent-stabilized buildings are often consistent with an expectation that the apartments will rapidly turn over from current tenants paying \$700 to \$800 a month to new tenants paying \$1,000 to \$1,200 a month. The apartments are not deregulated, but the rents increase through the combined effect of the 20 percent vacancy bonus and individual apartment improvements during vacancy, which allow the landlord to charge an additional dollar per month for each \$40 spent on improvements. The new tenants may have somewhat higher incomes than the original tenants, or they may have similar incomes but pay a higher proportion of their income as rent. Community Service Society research has shown that rent

is consuming an ever-higher share of low-income tenants’ earnings. This effect alone can drive a significant increase in rental property values.

The financing for Bronx Mitchell-Lamas bought by predatory equity investors are similar. For example, in 2006 Karasick bought two mid-Bronx developments, Robert Fulton Terrace and Fordham Towers, for a total of \$40.5 million. Karasick’s mortgage loan from the Canadian Imperial Bank of Commerce was securitized, and filings with the federal Securities and Exchange Commission (SEC) reveal that the buildings’ annual income is \$4,839,032 (an average apartment rent of \$823 a month) and the debt service is \$2,095,100. The filing reports a wildly unrealistic figure for operating expenses, equivalent to just \$301 per month per apartment. This makes it appear that building can operate comfortably in the black immediately, leaving plenty of net operating income with which to service the debt.

A more realistic figure for operating expenses of \$567 per apartment per month (the Bronx average found in research by the Rent Guidelines Board) results in total operating expenses over \$3 million, in which case the building cannot cover debt service with the net operating income. Such initial losses may be acceptable to Karasick, just as they are to Gluck at the Riverton, but the rent increases that can be obtained upon vacancy at these buildings are surely much lower than those Gluck is counting on in Harlem. In one scenario, Karasick

	3333 Broadway as Mitchell-Lama (2003)	3333 Broadway as market rate (2008)
Rent income	\$7.8 million	\$9.8 million
Subsidy	\$5.3 million	\$15.1 million
Total income	\$13.2 million	\$24.9 million
Operating	\$7.5 million	\$7.5 million
Ground rent and tax equivalent	\$0.8 million	\$4.8 million
Total costs	\$8.3 million	\$12.3 million
Net income	\$4.9 million	\$12.6 million
Debt service	\$4.7 million	\$15.0 million
Net cash flow	\$0.2 million	Loss of \$2.3 million

could lose money on the buildings for three or four years, but then begin turning a profit by turning over the tenant population at a rate of 10 percent a year and raising rents upon vacancy to \$1,000 to \$1,200. This scenario is a more realistic explanation why an investor would value these two buildings so highly – but it also a far more speculative scenario than the one presented in the SEC filing. If the tenants do not turn over as fast as Karasick would like, or if the vacant apartments cannot be rented out at sufficiently increased rents, it will take longer for the buildings to begin supporting their debt service, and the value of the building will not rise fast enough to allow a profitable resale. Like Gluck at the Riverton, Karasick could end up in danger of defaulting on the loan.

Predatory equity investments are a serious cause of concern for tenants and affordable housing advocates for two reasons. First, these investors must significantly increase the profitability of the assets they buy in order to reach their expected rates of return (or even just to avoid losses). When the asset is low- and middle-income housing, this can only be accomplished by raising rents significantly, so that the tenants in place are replaced by a new group of higher-income tenants. And second, the speculative prices paid by these investors, and the high degree of leverage in their deals, create the risk that income from the property will not be enough to support debt service, which can lead to inadequate maintenance, deteriorating conditions, and possibly foreclosure. In short, speculative investments place both tenants and the buildings themselves at risk.

Policy recommendations

Provide tools to New York City and nonprofit organizations to preserve distressed subsidized housing: The New York City Department of Housing Preservation and Development is continuing its excellent work in responding to physical distress, which has been the main threat to project-based Section 8 housing in New York City in recent years and also threatens a large number of Mitchell-Lama developments. HPD has worked closely with tenants, community organizations, nonprofit developers, and the development intermediaries LISC and Enterprise Foundation to find creative ways to improve conditions and preserve affordability in individual buildings. Just as important, it has collaborated with the same partners in lobbying for changes in federal policy

that will enable a true systematic response to the problem. Recently it established an Intergovernmental Working Group and hired new staff to augment this effort. In going forward, HPD should continue to emphasize close collaboration with tenants, community organizations, and nonprofit developers. Experience has shown the enormous value of an actively engaged tenant organization in finding appropriate solutions for distressed buildings.

Preserve Mitchell-Lama: Market-driven Mitchell-Lama buy-outs continue to be the largest threat to the subsidized housing stock, and the high prices paid by predatory equity investors have almost totally undermined the effectiveness of the New York City Housing Development Corporation and New York State Housing Finance Agency subsidized refinancing programs intended to preserve the Mitchell-Lama stock. The speculative risks taken by predatory investors also create a danger that buildings will fall into disrepair after being removed from the subsidy program if anticipated increases in rental income fail to materialize. The preservation subsidy programs, then, should be continued and perhaps augmented, but they must be matched with efforts to limit the speculative risks taken by buyers of subsidized and formerly subsidized buildings through closer supervision of proposed sales by the Mitchell-Lama agencies. There should also be a regulatory or tax “stick” in addition to the subsidy “carrot.” This could take the form of a higher real property transfer tax for Mitchell-Lama reorganizations that fail to preserve affordability. And, finally, the system of incentives, regulations, and taxes should be design to encourage the transfer of buildings to owners with a mission to provide affordable housing, such as low-income cooperatives or local community development corporations and other nonprofit organizations.

Protect Mitchell-Lama tenants: Tenants in Mitchell-Lama buildings are vulnerable to displacement after the buildings leave their subsidy programs. Some, but not all, tenants are eligible for federal enhanced vouchers to help pay higher market rents for their apartments. Some, but not all, are covered by rent stabilization. And those that are protected by rent stabilization may be vulnerable to unaffordable rent increases under rent stabilization’s “unique or peculiar circumstances” provision. The New York State Legislature should place all Mitchell-Lama apartments under the rent stabilization program in the event they leave the Mitchell-Lama program, and should mandate

that the initial rent-stabilized rent on each apartment be the last Mitchell-Lama rent, without any increase under “unique or peculiar.” In addition, the rent stabilization laws and anti-harassment laws should be diligently enforced to dispel the real estate industry’s perception that rent regulation can be circumvented. Reducing the rent increases allowed on vacancy and eliminating vacancy decontrol would also go a long way toward reining in speculative investment in both rent-stabilized and subsidized housing.

Preserve Mark Up to Market: The Mark Up to Market program appears to be extremely effective in preserving subsidized housing, especially in high-market areas. Congress should ensure that the annual HUD appropriation for project-based Section 8 continues to be sufficient to fund all needed Mark Up to Market activity. Mark Up to Market should also be treated as a model for preserving other parts of the subsidized housing stock. The other federal rent subsidies, Rent Supplement and Rental Assistance Program, should be converted to Section 8 at all buildings and thus made eligible for Mark Up to Market. (In August 2008, Congress mandated the conversion of Starrett City’s Rental Assistance Program subsidy to Section 8, but left the subsidies at all other developments unchanged.)

Give tenants and their chosen development partners a right to purchase: Nonprofit ownership can provide a long-term solution for the preservation of affordable housing. Government should promote this solution by mandating that for-profit owners sell subsidized developments to tenant-selected nonprofit preservation purchasers before removing the buildings from subsidy programs, if the nonprofit can pay an appropriate price. Both New York State and the federal government should pass legislation to create such a right to purchase, and they should also provide funds to help tenants and community-based developers use the right effectively.

Mandate stronger underwriting standards: If banking regulators required mortgage lenders to set and stick to underwriting standards for multi-family lending based on the documented financial performance of the buildings, they would reduce the likelihood of default and also protect tenants and communities from the harm that results from predatory investment activity. Limiting the amount of speculative risk that mortgage lenders could take on would decrease the displacement pressure and stabilize the now-exploding prices for buildings that house low-

income workers. Any discussion of banking regulation reform in response to the failures of large financial institutions and the current credit crisis should include multi-family as well as single-family lending issues.

Investigate securitization practices: The packaging of mortgage loans into mortgage-backed securities played a major role in the single-family mortgage debacle and is also often involved in predatory equity investments in multi-family housing. The extremely low claimed operating expenses in the Robert Fulton Terrace-Fordham Towers deal raises the possibility that large speculative risks are being passed on to mortgage-backed security investors without proper disclosure. The federal Securities and Exchange Commission and the New York State Attorney General should investigate these securitization practices, including for possible criminal charges.

1. Tom Waters and Victor Bach, Closing the Door: Accelerating Losses of New York City Subsidized Housing, CSS Policy Brief, May 2006. Tom Waters and Victor Bach, Closing the Door 2007: The Shape of Subsidized Housing Loss in New York City, CSS Policy Brief, May 2007.
2. For this purpose, the high-market area includes all of Manhattan south of Harlem; the middle-market area includes parts of Upper Manhattan, the areas of Brooklyn and Queens closest to Manhattan, plus Forest Hills, northeastern Queens and southeastern Brooklyn. This division reflects the state of the rental housing market in the period from 2001 to 2005: the low-market area consists of neighborhoods where the median monthly rent paid in 2005 by people who moved into their apartments from 2001 to 2004 was less than \$1,000, the middle-market area consists of neighborhoods where the median monthly rent paid by such tenants was at least \$1,000 but less than \$1,350, and the high-market area consists of neighborhoods where the median monthly rent paid by such tenants was at least \$1,350.
3. The data comes from the New York City Department of Finance’s Rolling Sales Updates and Annualized Sales tables, accessed at www.nyc.gov/html/dof/html/property/property_val_sales.shtml. The figures shown are the number of apartments in sales of buildings with at least four apartments for prices greater than zero.
4. The figures shown are median per-unit prices, including commercial units as well as residential apartments, for sales of buildings with at least four apartments for at least \$10,000 per unit, where the transactions are weighted by the number of units.
5. Median sales prices for residential buildings of five or more units accessed from the New York City Housing and Neighborhood Information Service, www.nychanis.com, sponsored by the Furman Center for Real Estate and Urban Policy at New York University School of Law and the Robert F. Wagner Graduate School of Public Service.
6. James Kelly, “Selling in pieces: As credit tightens, sellers break up portfolios.” The Real Deal, July 2008. Accessed at ny.therealdeal.com/articles/selling-in-pieces.
7. “Mideast investors lose interest in US real estate despite recent sales of landmark offices.” The Associated Press, July 28, 2008. Accessed at www.ihf.com/articles/ap/2008/07/28/business/NA-US-Properties-Mideast-Investment.php.
8. The Community Service Society is a member of the Partnership to Preserve Affordable Housing, along with New York State Tenants & Neighbors, the Urban Assistance Board, the Pratt Area Community Coalition, the Legal Aid Society, and South Brooklyn Legal Services.
9. For the national analysis, Microsoft Access was used to link the scores to other building information by matching the project name field in two databases – an imperfect system. Twenty percent of the projects failed to match, and some of those that did match, matched erroneously. None were corrected.
10. This financial analysis of 3333 Broadway is based on news reports of the building’s sale, information from the New York City Department of Finance, the building’s ground lease and amendments, and information from the government agencies that supervise Mitchell-Lama buildings.