Community Service Society | Fighting Poverty Strengthening New York

Closing the Door 2009: Risks of Boom and Bust

By Tom Waters & Victor Bach

SUMMARY

December 2009

New York City's housing market moved at a very slow pace during 2008, resulting in few changes to the city's supply of subsidized, privately owned rental housing. This comes as no surprise at a time when it is very difficult for investors to secure financing for any real estate activity. During 2008, 679 Mitchell-Lama units were lost in two buildings, one on Manhattan's Upper East Side and one in the West Bronx. In addition, 78 non-Mitchell-Lama units were lost in two small project-based Section 8 buildings. The total of 757 apartments lost is the lowest in any year since 2000, but the risk remains that rapid loss of this stock will resume once the financial markets recover.

Despite the small amount of activity on the surface, there are deeper changes going on in the conditions affecting the city's affordable housing stock.

Market trends: New York City's residential investment property market has been transformed dramatically by the financial crisis. City data show that the end of the boom in apartment building investments led to a bust in transaction activity throughout the city, and in sale prices in Manhattan below Harlem. But the bust does not show up in sales prices in the rest of the city. Although far fewer apartment buildings are being sold, and the prices at which they change hands have decreased from their peaks, the prices remain well above their pre-boom levels. This does not necessarily mean that apartment buildings in Upper Manhattan, the Bronx, Brooklyn, and Queens have held their value, however. The low number of sales means that to a large extent, the market has not yet spoken about the value of these investments. In fact these buildings are almost certainly worth less than the prices paid for them from 2005 to 2007, but there are not enough willing buyers and sellers – or perhaps not enough available financing – for a new, lower value to be expressed in the market.

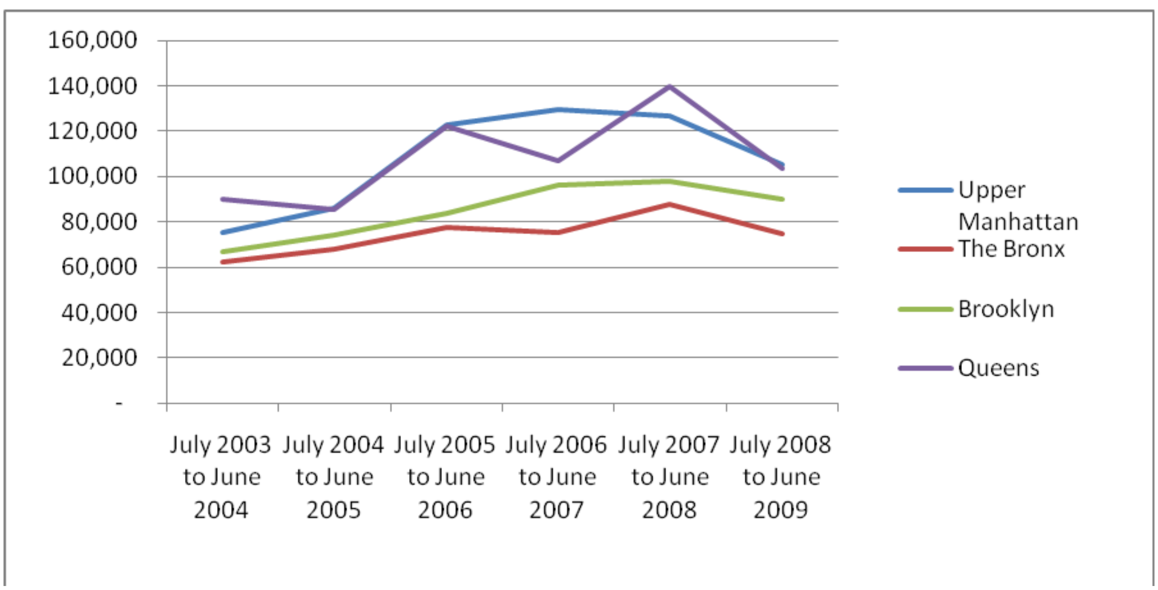
Predatory equity: The run-up in prices for rental apartment buildings was in large part driven by "predatory equity" investors, whose strategy was based on speculation that these building incomes had the potential increase greatly in the near future. When these increase failed to appear, the buyers were often unable to make mortgage interest payments, leading to a wave of defaults that is now well under way, with well over 4,000 apartments affected in the Bronx, Harlem, and East Harlem.

CSS analysis indicates that the buildings were bought at very high prices relative to annual rental income, and that prices did not moderate even after the economic downturn. In 2008 and 2009, more than 10 percent of the buildings were resold at prices that ranged from 25 percent below to 80 percent above their initial predatory purchase price. This pattern, with reductions in price limited to 20 to 25 percent, suggests that buildings are selling for the amount of debt outstanding on the properties, but never less. This in turn suggests that lenders are not permitting sales for less than the amount of debt. By blocking such "short sales," lenders can delay the appearance of losses on their financial statements and avoid the regulatory consequences of these losses. This lender intransigence helps explain why prices have failed to fully retreat from their boom levels. It also means that the market is not internally sorting out the problem of overleveraged buildings. The longer this goes on, the more buildings will begin to deteriorate as rental income falls short of the level needed for proper maintenance and debt service. Those buildings needing capital for major rehabilitation will be unable to raise that capital, causing even more deterioration.

Policy recommendations

- Combat the loss of subsidized housing and strengthen protections for tenants when buildings do leave subsidy programs.
- Reduce the exposure of subsidized buildings to predatory practices by establishing a federal "right to purchase" for tenants and their chosen development partners before allowing the properties to leave subsidy programs.
- Ensure that state and city governments have the resources to make the most of the current opportunities to improve affordability.
- Use existing New York State and New York City resources and knowledge of the local market to support preservation purchases of financially distressed subsidized, formerly subsidized, and other buildings by nonprofit organizations with a mission to provide affordable housing.
- Make federal resources available to support the restructuring of debt on overleveraged buildings in New York City and in other parts of the country where apartment buildings are in financial distress.
- Explore the possibility of a federal program to encourage responsible debt restructuring by reducing the regulatory consequences of reporting the related losses on balance sheets.

Median sales price per apartment, 2003 to 2009, excluding Manhattan below Harlem



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