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The Mortgage Hangover

A Bronx boom-and-bust story shows why the nation hasn't yet recovered from the financial crisis.

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As the American economy limps through its second "recovery summer," hobbled by trillions of dollars in bubble-era debt, politicians and regulators should take a long look at an unlikely place: Kingsbridge, a neighborhood in the northwest Bronx. In some ways, Kingsbridge's credit-bubble experience was no different from the rest of the nation's. As the bubble reached its greatest size in late 2006 and early 2007, the financial system—aided by dizzyingly intricate instruments and coddled by the government, which had long kept investors from facing the consequences of bad decisions—piled too much debt on Kingsbridge's modest dwellings. As a result, the buildings' owner abandoned them, leaving tenants to bear the brunt of somebody else's mistakes.

Yet Kingsbridge has also become a startling exception to what's happening in the rest of the country. A few people, acting within New York's regulation-strangled rental real-estate market, have produced a solution that harnesses the power of the marketplace to correct mistakes. They've pulled this off even as most of the country languishes in government-bailout purgatory. Washington should heed the lesson of Kingsbridge. If it doesn't, we're likely to spend another half-decade haunted by the bad debt of the past.

Kingsbridge, a mostly black and Hispanic hardscrabble neighborhood, is different from Las Vegas, Miami, and other go-go symbols of the mid-2000s credit bubble. Sergio Cuevas, an accountant at the nearby Albert Einstein College of Medicine, has lived in Kingsbridge for nearly three decades, in a brightly cluttered, rent-regulated two-bedroom apartment that he has shared with his two children since their mother died. "The baby got shot right over there," he says, gesturing out the window to the spot where a stray bullet wounded a three-year-old girl his mother was babysitting in 1993. Shootings are less frequent now, and the crime rate in general is lower. But this is still the northwest Bronx, nearly an hour from midtown Manhattan by subway. The median household income is just $29,000, and according to NYU's Furman Center for Real Estate and Urban Policy, nearly a third of Kingsbridge's households earn under $19,000 a year.

Five years ago, though, a California-based real-estate firm called Milbank announced that this humble reality represented instant opportunity. Calling the Bronx "one of the last boroughs to offer affordable rent, which would also be positioned to undergo significant gentrification," the company decided to buy properties, mostly in Kingsbridge, and transform them into luxury buildings, which would allow for "an improved tenant base and increased rental income." So Milbank plunked down $42.4 million for 551 apartment units in ten apartment buildings, including Cuevas's building on Sedgwick Avenue. That was about seven times the buildings' estimated "rent roll," or annual gross rental income. Paying even five times a building's rent roll is aggressive, say Bronx real-estate veterans (Milbank didn't respond to an interview request).

That excessive $42.4 million was just the start of Milbank's investment. To upgrade the buildings to luxury status, as its plan dictated, the company would have to spend a lot more money. An electrical overhaul would be necessary, for starters, since the residences' aging electrical infrastructure made it difficult for apartment dwellers to use two appliances at once without blowing a fuse, and many outlets didn't even work. Milbank would also need to fix leaking roofs and replace plumbing and heating.

All told, the upgrades would cost tens of millions of dollars, making Milbank's total investment in the buildings far higher than its rental income would cover. That should have been especially troubling because the other part of Milbank's plan—boosting rents with an "improved tenant base"—ignored an immutable fact of New York real estate: replacing lower-paying tenants with higher-paying ones isn't easy. New York law constrains annual rent increases. If landlords make major capital improvements, they can pass those costs along to their tenants, but they must do so over several years, not all at once. Yes, owners can raise the rent more for vacant apartments than for occupied units, but they must renew existing tenants' leases if the tenants want to stay on, so turnover is low. Owners can evict tenants who have illegally sublet their apartments or who lag on the rent, but removals can take years and are fraught with public-relations risks.

And it's not just the law that curbs rents. Even if Milbank succeeded in ejecting tenants and hiking rents, it still would have to compete for wealthier residents with neighborhoods nearer Manhattan. Affluent families, especially those with young children, would be nervous in a neighborhood like Kingsbridge, with its menacing pit bulls and loitering toughs. Younger singles would prefer to be nearer Manhattan's nightlife. A quick stroll around Kingsbridge and cursory knowledge of the New York real-estate market would have made these realities clear and suggested to Milbank that it was paying way too much.

To understand why a company would be so feckless—and why investors would throw money at it—you have to know something about the 2006 securitization bubble and a quarter-century's worth of government financial policy. Since the early 1980s, Washington had made it clear that if investors lent money to a financial institution that was sufficiently big or complex, the government would bail them out in a crisis. The government, in effect, subsidized the financial industry—and, not surprisingly, got more of it, including its main product: debt. Finance used this unfair advantage over other industries to grow ever bigger and more complex (see " 'Too Big to Fail' Must Die," Summer 2009).

Washington and other Western governments also counseled (and sometimes required) big investors, such as mutual funds and money-market funds, to select debt investments that carried AAA ratings, which supposedly denoted safety. To meet this demand, financial firms went to great lengths to transform junky debt into AAA-rated debt. In many cases, they accomplished this alchemy by purchasing loans from mortgage lenders and brokers, pooling these individually risky loans, and selling securities, backed by the entire pool, to investors. Because some investors in the pool agreed to take on more risk for a higher return—that is, they agreed to shoulder the bulk of any hypothetical losses—other investors in the pool could take *less* risk. That's how risky loans became securities carrying AAA ratings.

So it happened that in late 2006 and 2007, Deutsche Bank and Bank of America created a $3.7 billion pool made up of "commercial mortgage-backed securities." The pool was a mix of 172 debtors, according to the trust's 500-page informational document. It included a $340 million loan against the Mall of America, a $240 million loan against the former Enron building in Houston, and smaller loans against everything from mini-storage facilities to RV parks across the country. It included, too, $35 million worth of mortgages against Milbank's Bronx properties (Milbank also borrowed another $3 million in junior debt separately from Deutsche Bank). Having won AAA ratings on $3.4 billion of the pool, the underwriters sold the securities off to investors, which eventually included mutual and insurance funds managed by such firms as Goldman Sachs, Putnam Investments, Prudential, and Wells Fargo. At least one of these investors added another layer of complexity by purchasing "insurance" on its supposedly supersafe investment via a credit-default swap. Adding yet more opacity, Deutsche Bank separately transferred Milbank's junior debt to another trust, which Deutsche Bank kept on its own books.

You can start to see why investors would trust Milbank with their money. After all, they were so far removed from the facts of the deal that they might as well have been on another planet. No wonder they lent freely to a Los Angeles–based company with zero experience in the Bronx, at a time when the real-estate bubble was already bursting and commentators were warning of disaster.

To spend a day with people who actually know the Bronx real-estate business is to realize just how crazy the financial markets were in 2006. Matt Engel, whose family has managed rent-regulated Bronx buildings for decades, remembers one bubble-era real-estate prospector who created a multi-tab spreadsheet featuring complex, long-term projections of everything from regional personal income to oil prices. Landlords who know the business don't rely on such soothsaying, Engel observes. Instead, they often consult a single piece of paper that shows the year's rent roll; expected losses from tenants who don't pay; and rough estimates of big-ticket items, such as heating oil, water, and taxes.

The piece of paper also, of course, shows mortgage costs. Conservative-minded landlords, Engel explains, know not to borrow so much that they lack the cash to cover emergencies. Many refuse to borrow more than 60 percent of a property's value, even though lenders are willing to offer much more. (Milbank borrowed 90 percent of the funds for its Kingsbridge purchase.) Even a small change in petroleum prices can cost tens of thousands of dollars per building in heating, Engel says; if you've borrowed too heavily, you may not be able to make your mortgage payment when petroleum spikes or when you have to make an emergency repair.

Veteran landlords also have at their disposal a trove of information that wasn't available to the bubble-era securities underwriters, ratings analysts, lawyers, servicers, and consultants—even those toting complicated spreadsheets. These landlords know which tenants run into money trouble every few months but always pay the rent in the end, and which won't send in their back rent until faced with eviction. They know which tenants disable smoke detectors and remove child-safety guards from windows. They even know which tenants smoke carelessly. Landlords can delegate their work effectively—provided the third party knows that the owner is looking over his shoulder and understands the business. An elderly Bronx property owner can retire to Florida and pay a manager to handle his buildings, say, but only because he knows enough to be suspicious of any big change in income and outflow. The mutual-fund and insurance-fund investors whose money eventually found its way into Milbank's hands had no such knowledge.

Engel remembers the credit boom well. "There was all this money, institutional money, coming in," he says. Those investors who actually understood Bronx real estate looked on dubiously as the bubble got bigger and bigger. "People who know the Bronx haven't bought in ten years," says one Bronx property owner who prefers not to be named. As the Milbanks of the world came calling, many small landlords sold out, knowing that they wouldn't see these prices again in their lifetimes. "It was time to get out of the business," one owner recalls with a chuckle.

Belatedly, Milbank figured that out, too. In February 2009, two years after consummating its investment, the company realized that its business plan would never work; among other things, turnover among tenants was far lower than it had hoped. So Milbank walked away, deciding "not to throw good money after bad," said one person familiar with the company's thinking.

As the paperwork required, the trust that managed the debt for the ultimate investors—those mutual-fund holders, banks, and other institutions—transferred the Milbank "portfolio" to a "special servicer," a company called LNR Partners. The process looked straightforward. LNR would go to court to foreclose on the buildings, at a stroke wiping out much of the debt that Milbank had taken on. LNR would then sell the buildings to a new buyer—one who knew the business better—at a lower price. Investors in the mortgage trust would take big losses; Deutsche Bank, which still held the junior debt, would lose everything. And everyone—investors new and old, as well as tenants and neighbors—would get on with their lives. In an efficient marketplace, that would have been that.

LNR's actions in early 2009 followed the script. In March, it went to Bronx Supreme Court to start foreclosure. It asked for and got a court-appointed receiver—someone to collect rents and maintain the properties while they were in legal limbo. Everything seemed on track. But then LNR began to stall. The company repeatedly asked the Bronx judge, Stanley Green, to stay foreclosure. As the months passed and became a year, the ten buildings deteriorated. With effectively no owner, more than 3,300 housing-code violations went uncorrected. Tenants with means went elsewhere, leaving more than 100 units vacant across the portfolio. Meanwhile, the court-appointed receiver couldn't come up with the money for even elementary repairs. Some tenants stopped paying rent, while others sent more than $90,000 in rent to the wrong place—to Milbank.

Why the delay? LNR's reason for stalling was probably that foreclosure meant realizing a certain loss, whereas if the firm waited, it could hold out the hope of selling for a higher price later (the company didn't respond to an interview request). It had another incentive, too: investors in the trust could sue LNR if they thought that it hadn't done everything possible to get the best price. Plus, if Bank of America and Deutsche Bank thought that LNR was foreclosing too quickly and disposing of real estate at fire-sale prices, they might not recommend the special servicer for future jobs. Deutsche Bank would be doubly annoyed because the junior debt that it held would be rendered worthless if the senior debt suffered even small losses, as it likely would via foreclosure.

But why wouldn't the managers of the funds that bought the securities want their customers to take their inevitable losses and get them over with? The answer involves the way Deutsche Bank and Bank of America had created their pool of debt. Remember how $3.4 billion of the pool was AAA-rated? To this day, $2.5 billion of it *still* carries AAA ratings, and investors in that debt continue to receive their regular income because investors in the riskier "tranches," as they're called, have suffered all the losses as the performance of the underlying loans has disintegrated. But once the losses in a pool reach a certain point, even the AAA debt is affected and suffers ratings downgrades. The fund managers who hold AAA debt don't want that to happen, for obvious reasons.

LNR's policy of "extending and pretending," to borrow Wall Street's parlance, was encouraged, too, by the federal government. By keeping its key interest rate at zero percent, for instance, the Federal Reserve allowed the Milbank investors to keep borrowing cheaply and thus keep holding their bad debt. But the Fed went much further in discouraging a market solution for Kingsbridge. In autumn 2008, in a misguided attempt to keep the prices of mortgage-backed securities inflated, it started a program called TALF, the Term Asset-Backed Securities Loan Facility, through which it would lend cheaply to financial firms that offered those securities as collateral. In 2009, a financial firm called DMR TALF and ABS Funding LLC took the Fed up on this deal, offering its holdings of Milbank-related debt securities in exchange for a nearly $30 million loan.

This mechanism is forbiddingly obscure. But the result is easy to grasp: it helped everyone involved in the bad Kingsbridge debt hang on to it as long as possible. Meanwhile, the Bronx buildings kept deteriorating.

More than two years would pass before the investors in the Milbank deal finally took their losses so that everyone could move on. In April 2011, Milbank sold the buildings to a new landlord at a price more than 25 percent lower than its original 2006 purchase price. Counting liens, fines, and the like to close out the sale, Milbank's senior lenders probably lost about 26 percent of their original investment, observers estimate.

Deutsche Bank got nothing on its junior debt (except for its original underwriting fees).

It turns out, though, that the Milbank investors didn't take their losses entirely of their own volition. They did so because Kingsbridge residents organized themselves—a venerable New York tradition—and sought political and legal help. In early 2010, a legal-aid group called Bronx Legal Services took up the tenants' cause, arguing in Bronx Supreme Court that since the court-appointed receiver lacked the money for maintenance and repairs, the servicer, LNR, should have to pay up. When Judge Green agreed, ordering LNR to fork over $2.5 million, the investment equation for Milbank's investors suddenly changed. Waiting and letting physical assets deteriorate no longer promised the hope of full repayment but instead could cost money—and there was no guarantee that the payout would stop at $2.5 million. At the same time that Bronx Legal Services was going to court, two more nonprofits, the Urban Homesteading Assistance Board and the Northwest Bronx Community and Clergy Coalition, commissioned an architectural study that concluded that the buildings needed up to $25 million in repairs. Milbank's investors had to worry that a judge might order them to pay it all.

The investors had to keep an eye on New York City's government, too. New York has a long history of efficiently dispatching owner-abandoned properties. Back in 1986, the city owned 4,000 occupied apartment buildings and almost 6,000 vacant ones, the legacy of the high crime rates and white flight of the sixties, seventies, and early eighties. Gotham has worked relentlessly to put these buildings into private hands, and today it controls far fewer.

In late 2010 and early 2011, the city was showing signs of seizing the Kingsbridge buildings. New York subpoenaed LNR to learn more about the properties' finances, and Mayor Michael Bloomberg, City Council Speaker Christine Quinn, and other officials pointedly toured the properties and announced a new program to deal with buildings whose indebted owners had abandoned them. It didn't hurt that a key staffer for Bronx borough president Ruben Diaz, Jr., lived in one of the buildings. Suddenly, cutting losses seemed the rational thing to do. Deutsche Bank went so far as to transfer its $3 million in junior debt to the city for a dollar, washing its hands of the matter.

New York has hardly become a free-market paradise for real estate, however. As many as 100,000 apartments remain in debt-laden limbo. In April, a 12-year-old boy and his parents died in a fire in a three-story rental in the Bronx. They had been able to remain in their illegal apartment, which violated city fire codes, in part because their landlord had abandoned the property after taking on more debt than he could afford.

The new owner of what are now known as the "Milbank buildings" is Steve Finkelstein, whose company has owned and managed rent-regulated properties in the Bronx for 40 years. He has already begun replacing windows and has promised the city to close out serious housing violations within a year.

Finkelstein is taking a risk, but it's a measured one, and he has years of experience to back up his purchase. He bought the buildings for $31 million and figures that he can do the necessary repair work for about $11 million more. He reasons that new tenants will be willing to pay in the high three digits and low four digits a month for renovated, vacant apartments—well within the range allowed by New York's rent regulations. Finkelstein figures that his purchase price will work out to about five times the rent rolls, not nine, as was the case with Milbank. Over many years, he thinks, the buildings will yield an annual profit of $800,000 to $1 million. "At $31 million, these work as rentals," he says. Milbank, by contrast, "was buried."

Finkelstein's deal illustrates that debt is fine, but in moderation, and only when lender and borrower alike know what they're doing and are accountable for the risks that they're taking. Finkelstein is borrowing about

$30 million for his purchase—but he's borrowing not from an anonymous trust that is the agent of an agent of an agent of some investors, but from a bank that understands the rental market, is taking a calculated risk, and will hold its investment until it matures. Finkelstein's lender, Signature Bank, knows what to look for in such a transaction, says George Klett, who runs Signature's commercial real-estate lending shop. "Finkelstein is a very good client of the bank," says Klett. "You do repeat business, you bet on the jockey." Still, the bank's knowledge of the neighborhood, the properties, and the competition means that it's charging Finkelstein a comparatively high 6 percent interest rate on his loan. "Since the property is in poor physical condition and is in need of substantial repairs, we deem it to be additional risk," Klett says.

Some Bronx veterans still consider property valuations too high. In fact, some of Finkelstein's fellow landlords think that he is paying too much. But if that's the case—if it turns out that Finkelstein, like Milbank, isn't able to pay his debts—the results should be far simpler than they were after Milbank threw up its hands: either an ordinary foreclosure, a negotiation with his lender, or a prompt sale to another landlord.

The rest of the country looks a lot like Milbank in early 2010: rotting while investors play pretend. Between 2000 and 2007, Americans borrowed more money more quickly than ever before, mostly by using their single-family homes as ATMs. Mortgage debt exploded, from $4.8 trillion to $10.6 trillion; today, it still stands at a staggering $10 trillion. At least a quarter of American home borrowers owe more than their houses are worth; millions more are close to that line and grow closer as property values continue their slow descent; so many are delinquent on their mortgages that in Florida, for example, the *New York Times* estimates that completing all eligible foreclosures would take a decade. All this debt is kneecapping the economy. Americans are using their money to pay for bubble-era mistakes, rather than investing in companies that create jobs, saving money for their children's education, or putting away funds for their own retirement.

Just as LNR should have foreclosed promptly on the Kingsbridge buildings, financial firms should foreclose on delinquent mortgages, speeding up the painfully slow process of getting rid of the nation's surplus debt and freeing up money to start rebuilding the economy. But many of the mortgages are trapped in layers of securities at least as complex as the loan pool that held Milbank's debt—and for the investors who hold those securities, it pays to wait. The four big banks that hold nearly half of the nation's second mortgages—junior debt—don't want to be wiped out, any more than Deutsche Bank wanted its junior debt on Milbank to vanish.

Homeowners, too, have good reasons to delay. The federal government's policy is to keep housing prices artificially inflated—for example, through President Obama's 2009 tax break for first-time homebuyers. No surprise, then, that homeowners are hanging on, hoping that somehow they'll be able to sell high.

Solving the problem won't be easy. One obvious step: the Fed could allow interest rates to rise, raising costs for borrowers and forcing them to give up bad debt. Regulators could also set a deadline on foreclosures, giving banks and servicers six months, say, to take back property whose mortgage holders are more than 90 days delinquent; banks that couldn't comply would be compelled to write down the principal on such mortgages, thereby reducing the nation's debt. Whatever the solutions are, one thing is clear: America, like the Kingsbridge buildings a half-decade ago, owes too much money. Until it reduces its enormous debt burden, economic recovery will continue to flag.

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