



Home > Real Estate

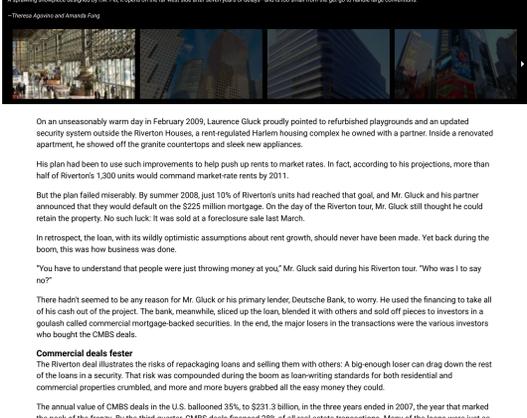
June 27, 2010 12:00 AM

Low Ranieri and the road to hell

Theresa Aguiro

ES EMAIL | FB SHARE | TWITTER | IN SHARE

REFERENCES



1986
A sprawling skyscraper designed by I.M. Pei. It opens on the far west side after nearly years of delays—and is too small from the get-go to handle large conversions.
—Theresa Aguiro and Amanda Fung

On an unseasonably warm day in February 2009, Laurence Gluck proudly pointed to refurbished playgrounds and an updated security system outside the Riverton Houses, a rent-regulated Harlem housing complex he owned with a partner. Inside a renovated apartment, he showed off the granite countertops and sleek new appliances.

His plan had been to use such improvements to help push up rents to market rates. In fact, according to his projections, more than half of Riverton's 1,300 units would command market-rate rents by 2011.

But the plan failed miserably. By summer 2008, just 10% of Riverton's units had reached that goal, and Mr. Gluck and his partner announced that they would default on the \$225 million mortgage. On the day of the Riverton tour, Mr. Gluck still thought he could retain the property. No such luck: It was sold at a foreclosure sale last March.

In retrospect, the loan, with its wildly optimistic assumptions about rent growth, should never have been made. Yet back during the boom, this was how business was done.

"You have to understand that people were just throwing money at you," Mr. Gluck said during his Riverton tour. "Who was I to say no?"

There hadn't seemed to be any reason for Mr. Gluck or his primary lender, Deutsche Bank to worry. He used the financing to take all of his cash out of the project. The bank, meanwhile, sliced up the loan, blended it with others and sold off pieces to investors in a goulash called commercial mortgage-backed securities. In the end, the major losers in the transactions were the various investors who bought the CMBS deals.

Commercial deals fester
The Riverton deal illustrates the risks of repackaging loans and selling them with others: A big-enough loser can drag down the rest of the loans in a security. That risk was compounded during the boom as loan-writing standards for both residential and commercial properties crumbled, and more and more buyers grabbed all the easy money they could.

The annual value of CMBS deals in the U.S. ballooned 35%, to \$231.3 billion, in the three years ended in 2007, the year that marked the peak of the frenzy. By the third quarter, CMBS deals financed 28% of all real estate transactions. Many of the loans were just as dodgy as Mr. Gluck's.

In May, 8.4% of loans in CMBS deals were in foreclosure or delinquent, up from 0.5% in May 2006. This is widely seen as the beginning of a real estate failure that could hurt the U.S. economy for years, just as a 30-year-old financial crisis continues to weigh on Japan.

While regulators have concentrated on the bigger meltdown in residential mortgages, the commercial problem has been allowed to fester, with government officials allowing banks to extend loans rather than write them down.

About \$1.5 trillion worth of commercial real estate loans will need to be refinanced in the next five years. Analysts calculate that there will only be enough cash to fund half of that through lenders. But the CMBS market is a shade of its former self; it shrank to \$2.6 billion last year. Clearly, something will have to give.

"The market came to rely on CMBS as the vehicle of choice," says Manus Clancy, a managing director at Trepp, which tracks real estate debt. "Now we have a vacuum, because nothing is coming to replace it."

The many New York deals that were financed using the CMBS tool range from the Riverton Houses to Harry Macklowe's disastrous \$7 billion purchase in 2007 of seven office towers, which he was forced to return a year later. Only California has had more CMBS-fueled transactions.

In the beginning...
In fact, over the past few decades, a series of New York-based financiers sowed the seeds for the CMBS disaster. Each had his own twist on the product that helped channel more cash into what became an orgy of real estate speculation.

It didn't start out that way, back in the late 1970s: The concept of securitizing mortgages stemmed from a desire by Brooklyn-born and -bred Lewis Ranieri to devise a way for more people to buy homes. In a testosterone-soaked atmosphere closer to that of Animal House than an investment bank, he and his young team at all-powerful bond house Salomon Brothers staged hamburger-eating contests and other frat-boy stunts as they developed one of the most innovative financial instruments of the 20th century.

The idea was to bundle up large numbers of ordinary residential loans and sell them to investors as bondlike instruments called mortgage-backed securities. Salomon would make a fortune selling the bonds, and the banks that originated the mortgages could quickly sell them, generating cash for more loans so that more Americans could buy homes.

"This was not about housing as a luxury, but housing as shelter—a basic need for human civilization," says Mr. Ranieri, who now runs several businesses that invest in real estate and mortgages.

He started at Salomon as a part-time mail-room clerk in 1968, rising to become a vice chairman. He devoted four years to creating the first residential mortgage-backed security, which debuted in 1978, and spent much of the next six years shuttling to Washington and getting federal laws changed to make selling the securities easier. In his meetings with lawyers, regulators and elected officials, Mr. Ranieri often crossed paths with another financial innovator who was trying to get a new product off the ground: Michael Milken, the father of the modern junk-bond market.

"I think we both know more ways to get rejected than anybody," Mr. Ranieri says.

It didn't take long for Salomon to find another use for the securitization concept: financing commercial mortgages for office buildings, apartment houses and shopping malls. Salomon's first CMBS deal was a small affair, in which it sold \$25 million in mortgages for a now-defunct bank. But by the mid-1980s, Mr. Ranieri and his team raised nearly \$1 billion through a CMBS transaction for Olympia & York, one of the largest developers in the world at the time.

Spreading influence
Mr. Ranieri's influence manifested itself in the commercial market in other ways, too, as traders from Salomon's thriving mortgage desk dispersed to play prominent roles elsewhere.

Among them was Andy Stone, who landed at the Manhattan office of Daiwa Securities in 1990 and took the market in another new direction. He started buying up loans on mobile homes and apartment houses from Resolution Trust Corp. in Washington and packaging them into securities.

The RTC had been set up by the government in 1989 to take over mountains of sound loans from failed savings and loans. Mr. Stone and others purchased those loans for pennies on the dollar, then bundled and sold them to investors at a profit. "Andy was brilliant," Mr. Ranieri says. "He was always taking it to the next level."

Mr. Stone later moved to CS First Boston, where he eventually became one of the biggest funders of Manhattan real estate. He provided loans for winding megajobs including Steve Witkoff—a former partner of Mr. Gluck's who now owns properties such as the Woodworth Building—as well as more established figures like Peter Kalkov, who spent on to serve as chairman of the Metropolitan Transportation Authority.

Bundling big-time
Master marketer Ethan Penner, however, really put CMBS on the map. As head of the CMBS group at Nomura in the mid-1990s, Mr. Penner identified a fundamental problem in the market: The

owners of real estate, the bankers who financed the projects and the bond buyers who made the purchases didn't really know each other. He decided to introduce them, Wall Street style.

Mr. Penner staged lavish parties modeled on Mr. Milken's famed predator's balls, roping in some of the era's biggest names in music, including the Eagles and Stevie Nicks. Elton John kicked off the first party in 1994 with a two-and-a-half-hour concert in Boca Raton, Fla. "Grown men were crying, he was so good," Mr. Penner says. "It almost made me want to be gay."

The lavish events more than paid for themselves.

"Guys would tell me their wives said they had to do business with me so that they'd keep getting invited to the parties," he recalls.

The parties helped stoke demand as Mr. Penner set about expanding the use of the product. Previously, CMBS deals had centered around a single large property or several small loans. But one night in 1993, over dinner with an executive from Fitch Ratings at Raulo's, a French bistro on Prince Street in SoHo, Mr. Penner had an idea: Create a mega pool that bundled several large loans. The first deal, which closed a year later, was valued at \$610 million.

That paved the way for banks to stuff even more loans into each security, sending them scurrying to find additional borrowers. In 1996 and 1997, Nomura topped the list of companies securitizing commercial loans, according to Dealogic.

The Russian debt crisis of 1998 chilled the dot-com bubble, but it recovered quickly. It took another hit after the terrorist attacks of Sept. 11, 2001, and the deflating of the agoli.com bubble.

However, by 2003, CMBS was heating up again, along with the economy, and more banks were scrambling for a piece of the action, especially North Carolina-based Wachovia, now part of Wells Fargo. In 2002, Wachovia dispatched Robert Verone, the New Jersey bred son of Italian immigrants, to bolster its effort in Manhattan. Eventually, he earned the nickname "Large Loan Verone"—a moniker he hates—because of the massive sums he was willing to lend.

Underwriting on the wall
Mr. Verone had wanted to be a leader in the industry since he joined Bear Stearns in 1990. He was fired four years later, he says, for constantly badgering his superiors about the bank's failure to become a major force in the CMBS market. "I would have fired me, too," he teases.

Wachovia became the powerhouse he dreamed of, but the consequences were enormous. The bank underwrote some of the biggest disasters of the real estate boom: the \$5.4 billion purchase in 2006 of the sprawling Stuyvesant Town/Peter Cooper Village apartment complex, which is in foreclosure, and the \$8 billion purchase in 2007 of the Extended Stay Hotels chain, which is now in bankruptcy.

In the Stuyvesant Town deal, one marketing document estimated that 15% of the apartments in the largely regulated complex could be converted to market-rate rents in the first year. Historically, only 6% of units had been converted annually. In the Extended Stay deal, the borrower put up 7.5% of the purchase price, meaning that 92.5% of the deal was leveraged. There was simply no margin for error.

Both transactions highlighted financiers' increasingly lax underwriting standards—the result of soaring real estate prices, galloping rents and rising hotel rates. These factors led bankers to make loans based on heroic assumptions about borrowers' abilities to jack up revenues or reap huge profits by quickly reselling their properties. It also persuaded them that there was no need to test the viability of projects and have borrowers put much of their own skin in the game.

By the first half of 2007, the proportion of interest-only loans—which don't require borrowers to pay back principal until the maturity date—in CMBS deals had risen to 61%, from 21% in the first half of 2004, Barclays Capital says. Similarly, 21% of loans were based on underwriting of future cash-flow growth assumptions instead of actual performance; no such loans were included in deals in 2004. And in early 2007, cash flow was less than 1.2 times debt service in 37% of loans—up from 13% of such risky loans in 2004.

The combination of such shaky standards and falling property values spells disaster when loans come due. A full 56% of the CMBS deals written in 2007 involve loans that are now more than the buildings themselves—to the tune of 110% or more of the value of the properties.

"Begging for deals"
Bankers say that such nightmares were inconceivable when the transactions were financed. "Real estate had been going up and up for years," says Mr. Verone, who now runs his own shop in New York. "I had people begging me for pieces of these deals. I gave them what they wanted."

Wachovia was not alone, of course. When other bankers and dealersmen saw how many investors were buying Wachovia's aggressively valued loans, they began following suit. Otherwise, they'd risk losing out on the big fees generated by big deals.

"Everybody has lousy deals," says Mr. Verone. "Everyone has blood on their hands."

There was hardly any pushback from Standard & Poor's, Moody's and the other rating agencies, whose stamps of approval convinced investors that the securities were safe to buy.

Moody's and Standard & Poor's didn't make executives available for comment.

"Yes, it was a frothy time, and hindsight makes us very smart," says Husley Somerville, a group managing director of structured finance at Fitch. However, he adds, "We provide opinions, [and] ratings are not bulletproof."

Danger, Will Robinson
By late 2006 and 2007, some agencies finally started ringing the warning bells, criticizing the deteriorating lending standards. In April 2007, Fitch wrote that "[t]he subprime residential mortgage crisis should caution CMBS investors about the dangers of mixing aggressive underwriting with reliance on continued price appreciation."

The alarm went unheeded. Less than a month later, Tishman Speyer and Lehman Brothers agreed to pay \$22 billion for Archstone-Smith, owner of about 83,000 apartment units across the country. Lehman was eager to underwrite the massive deal, especially since longtime client Tishman Speyer had selected rival Wachovia to underwrite its purchase of the Stuy Town acquisition.

Lehman followed through on the deal despite signs that the economy was sinking. It was left holding much of the debt, which became a significant factor in the company's bankruptcy filing in 2008.

Despite the recent destructive legacy of CMBS, some experts say it will rise again—albeit with much tighter standards.

"It is still an efficient way to finance real estate," says Michael Mazzei, a former Lehman real estate executive who is now managing director of real estate structured finance at Bank of America.

Through mid-June of this year, there were at least nine CMBS deals worth nearly \$6 billion. That's up from the six transactions worth \$2.6 billion that were completed in all of 2009.

Last month, while bankers plotted the resurrection of the financing tool, Mr. Ranieri started a business to assist commercial property owners who are struggling to pay their mortgages. He's already started a fund to help homeowners hang on to their properties.

"There is so much real estate debt sitting on banks' books and in CMBS deals that it isn't going to be possible to roll it all over," says Mr. Ranieri.

He believes that he and his partner in the commercial enterprise—Jon Vaccaro, former head of Deutsche Bank's global real estate business—will be able to use their combined expertise to find new investors for the loans they've helped restructure.

The projects are a sort of penance, albeit a profits-making one, for a man who can't believe what sort of havoc his industry has brought. He says that in 2005, he began warning of coming problems in the securitization market in speeches to his creation. But he wasn't forceful enough, he thinks.

"I feel I failed in not getting out the message of what was wrong," Mr. Ranieri says. "I can't help but feel I should have done a better job."

RELATED ARTICLES

Reliving New York's glory days of junk bonds and hostile takeovers

Projects that reshaped 25 years

RECOMMENDED FOR YOU

- Rising apartment inventory not bringing down rent prices in some neighborhoods
- Upper West Side food hall run by Cipriani moves toward shutting down
- TF Convertstone links long-term ground lease at Billionaires Row's Tower 57
- Sponsored Content: Engineering a groundbreaking partnership

Most Popular

- Rudy Giuliani sells his US apartment for less than \$5M
- Vacant downtown Brooklyn office tower could undergo residential conversion
- Cleveland Guardians co-owner pays about \$18M for a condo on Billionaires Row
- City seeks approval to build 200 affordable apartments on Harlem public-hospital site
- Designer Alexander Wang buys landmarked Rowery bank site for about \$10M



GET OUR NEWSLETTERS
Staying current is easy with Crain's news delivered straight to your inbox, free of charge. Click below to see everything we have to offer.

Enter Business Email [SIGN UP HERE](#)

SUBSCRIBE TODAY!
Don't miss the chance to get the biggest news first! Stay connected to New York business news in print and online.

SUBSCRIBE

CONNECT WITH US

[f](#) [X](#) [in](#) [@](#)

Our Mission
Crain's New York Business is the trusted voice of the New York business community—empowering businesses across the five boroughs by providing analysis and opinion on how to navigate New York's complex business and political landscape.

CRAIN'S NEW YORK BUSINESS
A CRAIN FAMILY BRAND

CONTACT US
985 Third Avenue
New York, NY 10017
1-877-824-4379

Contact us / Help Center

Staff directory

Crain jobs

EVENTS
Submit Your Event

All Upcoming Events

Past Crain's Events

Past Crain's Events

Webcast Archives

Livestreams

Corporate Membership

RESOURCES
Advertise with Us

Crain's Content Studio

Crain's New York Business app

Newsletters

Reprints

Ad Choices

Signup

Corrections and Clarifications

LEGAL
Terms and Conditions

Privacy Policy

Privacy Request