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DFS Issues Guidance and Best Practices for State-Chartered Institutions Making Loans Secured by Rent-Stabilized Multifamily Residential Buildings

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Prompted by complaints it has received that certain owners of rent-stabilized multifamily residential buildings have engaged in inappropriate practices including tenant harassment and unsafe living conditions, the New York State Department of Financial Services ("DFS") has issued guidance and best practices (the "Guidance") for New York State financial institutions on making loans to such owners. The Guidance, which includes pre-loan due diligence and post-closing monitoring, is designed to prevent state charted financial institutions from "knowingly or unknowingly" facilitating "landlords' schemes to harass tenants and violate New York rent regulations."

The September 25, 2018 Guidance states that DFS has become aware that "certain landlords of rent stabilized buildings routinely have been deferring necessary and required maintenance and property costs needed to operate the multifamily residential buildings they own, thus violating tenant leases and disturbing their right to quiet enjoyment of their homes; that certain landlords have forced eviction or buy-out of tenants from their apartments, including those protected by New York's affordable rent regulations; and that certain landlords have used the proceeds from their bank loans to renovate such apartments in order to lease them out to new tenants at higher rents as quickly as possible in order to remove the apartments from rent stabilization."

DFS states that it "has been further alleged" (without stating by whom) that "lending institutions may have knowingly or unknowingly facilitated misconduct by these landlords." Two examples of such misconduct provided in the Guidance are: (1) including loan terms that require a landlord of a rent stabilized building to embark "on a hyper-aggressive plan to drive up rents in some of these buildings in order to pay off the loan within a relatively short period of time," and (2) making loans that the lending institution "should have known or predicted at the outset that a landlord default is likely based on the real rent rolls of the building, resulting in mismanagement of the building and other violations."

To address these concerns, the Guidance suggests best practices that include certain pre-loan due diligence, and then post-closing monitoring of loans.

For pre-loan due diligence, DFS recommends four specific measures for lenders to take.

1. Lenders should conduct appropriate due diligence on property owners, including when the lender's role is providing indirect financing to the property owner through a third-party vehicle, as if the end user is the

lender’s customer. For example, lenders should conduct background checks and lien searches, engage with tenant organizations, review information available from tenants and tenant organizations, search for the existence of any tenant lawsuits, and review available tenant complaints, available landlord alert lists, media coverage concerning property owners or problems at the property, and otherwise evaluate experience and reputation of property owners.

2. Lenders should conduct appropriate due diligence on properties, including when the lender’s role is providing indirect financing to the property owner through a third-party vehicle, as if the end user is the lender’s customer. For example, lenders should inspect and review the property's condition prior to closing, conduct due diligence regarding outstanding housing code and building violations with New York City’s Department of Housing Preservation and Development or other applicable housing authorities, and conduct due diligence regarding building permits, eviction rates, high vacancy rates, and loss of rent regulated units. This shall include enhanced diligence when a property has a relatively high number of violations. If feasible, lenders providing indirect financing should conduct their own due diligence on properties. If it is not feasible for such lenders to conduct their own due diligence on properties, they should seek the results of due diligence from the direct lenders.

3. Lenders should ensure realistic and sound underwriting terms for any loan involving a multifamily residential building. Examples to help lenders achieve this outcome include:

    1. Hiring reputable, independent appraisers to provide accurate property appraisals, such as the use of Member of the Appraisal Institute peer-reviewed appraisers;
    2. Establishing a debt service coverage ratio that is based on the specific facts of each loan and on realistic assumptions, subject to documentation, that utilize only current in-place rents (including preferential rents) and legally permitted rent from existing vacancies at the time of closing without any assumption that the owners will increase rents on the turnover of the currently occupied rent-regulated units;
    3. Use of realistic operating expense levels supported by appraisals and cost averages, such as those published by New York City, including reserves for normal maintenance and capital expenditures; and
    4. Ensuring that additional debt is not placed on a property without the lenders' prior consent.

4. Lenders should ensure that their loans do not become displacement financing, for example, using the loan for the purpose of tenant buyouts that may lead to their displacement.

As for the post-closing monitoring, DFS states that:

- Lenders should establish covenants or procedures to ensure that emergency and hazard repairs, including current and prior year violations of class “C”, “B” and applicable “I” violations, are corrected within six months of the loan closing.
- Lenders should take into consideration the level of responsiveness and willingness of a property owner in addressing concerns about building code violations, as a factor for future loans to the property owner.

The Guidance is directed to New York State chartered financial institutions, such as New York chartered banks, savings banks and credit unions. The Guidance is not directly applicable to federally chartered institutions.

The Guidance is available here. If you have any questions regarding the Guidance, please feel free to contact Joseph D. Simon at (516) 357-3710 or via email at jsimon@cullenanddykman.com, Elizabeth A. Murphy at (516) 296-9154 or via email at emurphy@cullenanddykman.com, or Mandy Xu at (516) 357-3850 or via email at mxu@cullenanddykman.com.

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