HOUSING & THE CREDIT CRISIS

MANHATTAN’S OFFICE LEASING MARKET

BUILDING A NATIONAL RAIL SYSTEM
MORTGAGES, FINANCE MARKETS, AND THE IMPERATIVE OF GROWTH
The new mortgage-backed securities were supposed to have been low-risk investments.
By Hugh Kelly

BURNING DOWN THE HOUSE
First and foremost, trust, confidence, and stability must be restored in the mortgage transaction.
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FANNIE MAE AND FREDDIE MAC
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BUILDING A NATIONAL RAIL SYSTEM
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MANHATTAN’S OFFICE LEASING MARKET
Everything is available, at much lower rents and better terms.
A Panel Discussion

EATING AT JUBILEE
Traditional French cooking may be the best antidote to economics and public policy.
By Jasper Jones
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THE TRAJECTORY OF OUR BOOM ECONOMY masked systemic weaknesses that led to a resounding crash, its magnitude surpassing a mere cyclical problem. To regain some measure of economic preeminence and credibility, America must chart a new course.

The economic terrain is far more complex than during the Great Depression. When one sector of the economy—an overheated home mortgage market—collapses, new financial vehicles, new technologies, and an intricate global economy now spread the pain.

IT WORKED, UNTIL IT DIDN’T: WHY THE BUBBLE BURST

In this issue, three authors illuminate various aspects of the sub-prime mortgage debacle, analyzing what went wrong and what reforms are needed. Hugh Kelly, Sarah Gercke and Robert Van Orden unravel the complex factors that created the bubble and its subsequent burst. In addition, a panel of real estate experts discusses the impact of the financial crisis on the Manhattan office market, discerning some hopeful signs amid the chaos.

The securitization of sub-prime mortgage loans masked a risky foundation. Seduced by high yields in an overheated market, investors—bankers, brokers, rating agencies and even regulators—was put in escrow. This suspension of disbelief was exacerbated by insufficient checks and balances.

The impact of foreclosures is profound for neighborhoods and families. The pernicious effect of widespread dislocation on the community and character of communities can be wrenching. To restore the confidence of consumers and investors in the lending industry, standards should be reset closer to the criteria typical of prime mortgages. Reforms must also unravel the maze of securitized debt, to clarify property ownership and help neighborhoods recover. Trust and transparency are imperative.

THE SERENDIPITOUS DIVIDEND: ENVISIONING A MODERN AMERICAN RAILWAY SYSTEM

The stimulus package born of economic chaos presents a new opportunity to launch America into the twenty-first century in rail transportation, a serendipitous dividend to a national trauma. Because of our love affair with the car, we have lagged behind other nations in public transit. The Obama administration’s new initiatives herald robust investment. In addition to high-speed rail, John Philip highlights the need for several lower-cost, near-term improvements to the basic rail system.

ECONOMIC REFORM MUST BE COMPREHENSIVE

As Americans, we have taken for granted our miraculous economy, trusting that, despite cyclical vicissitudes, the market would always self-correct. The staggering meltdown of recent months has been a sobering wake-up call.

Effective reform must be comprehensive. Confidence cannot be restored without ensuring accountability, transparency, higher fiduciary standards, appropriate capital reserves and meaningful oversight throughout the financial industry.

If there is an underlying thread connecting these essays, it is that economics cannot be reduced to mere mathematical formulae. Judgment, moral values, and human nature have a role in how we construct and implement our economic system. The reforms undertaken cannot be cosmetic; recovery demands fundamental change.

We are at a defining moment: a paradigm shift must occur, to re-engineer capitalism if it is to survive the new century. Our economy, and the public interest, demand greater protections against recurrent crises of this depth. American taxpayers have assumed a heavy burden in bailing out a private sector which lacked prudent self-restraint. A multi-trillion-dollar bailout makes the citizenry substantial shareholders, expecting a return on their investment.

Therein lies the controversy: those resistant to change perceive any checks on the private sector as abandonment of the very capitalist system, the great economic engine of American success. The reform measures championed by Theodore Roosevelt and later by Franklin D. Roosevelt’s New Deal, were met with cries of heresy, warning of capitalism’s demise. Instead, corrective measures reestablished it. Today’s crisis similarly demands visionary reform.

Adjustments are clearly needed to thwart the downward spiral: to save it from itself, the current model of capitalism must be modified. Neither laissez-faire capitalism in its extreme, nor an overly intrusive regulatory scheme will foster a thriving economy for our future. Balanced reforms are needed, with stronger intervention to ensure stability and accountability, without stifling the opportunity and individual drive which have traditionally been the hallmark of America’s economic prowess.

As the ancient Chinese curse cautions, “May you live in interesting times.”

— Gail Shafter, Associate Editor
**TEN COMMANDMENTS FOR 21ST CENTURY REAL ESTATE FINANCE**

I. WRITE UPON THY HEART THE LAW THAT ‘REWARD’ AND ‘RISK’ SHALT ALWAYS APPEAR IN THE SAME SENTENCE. II. MAKE NEITHER MARKETS NOR REGULATORS INTO IDOLS, AND FOLLOW NOT FALSE PROPHETS OF SIMPLISTIC BIAS. III. BE SOBER AND WATCHFUL, LEST THE ENEMY OF MASSIVE LOSS APPROACH LIKE A THIEF IN THE NIGHT. IV. HONOR THY FATHER AND THY MOTHER’S ANCIENT COUNSEL: KEEP IT SIMPLE, STUPID! V. IF THOU WILT NOT DO THY OWN CREDIT ANALYSIS, THEN VOW TO INVEST NOT AT ALL. VI. THOU SHALT NOT ADULTERATE THY PORTFOLIO WITH EXCESSIVE LEVERAGE. VII. THOU SHALT NOT BEAR THE FALSE WITNESS OF HIDDEN ASSUMPTIONS IN THY INVESTMENT UNDERWRITING. VIII. THOU SHALT NOT COVET FOR THE SHORT TERM, YEA, BUT SHALT LAY UP THY TREASURES FOR LENGTH OF DAYS. IX. IN ALL THINGS, YIELD NOT TO THE TEMPTER’S SNARE OF PANIC. X. REMEMBER THAT, AFTER THY EXILE IN THE WILDERNESS, IF THOU HEEDEST THESE COMMANDMENTS, THOU SHALT ONCE AGAIN RETURN TO THE LAND OF MILK AND HONEY.

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**MORTGAGES, FINANCE MARKETS, AND THE IMPERATIVE OF GROWTH**

**ORIGINALLY I CONSIDERED THE SUB-PRIME MORTGAGE DEFAULTS TO BE ‘PRODUCT FAILURE’ RATHER THAN ‘INDUSTRY FAILURE.’** In August 2007, sub-prime defaults were a small percentage of the U.S. residential market. The total of sub-prime mortgage loans outstanding was $1.5 trillion, even after several years of explosive growth, and delinquencies among sub-prime loans were 13%—indicating trouble with about $195 billion of this risky debt. Losses appeared to be ‘containable’ within the context of the $10 trillion residential mortgage system. I was not alone in my judgment. The contagion of fear that traveled through global financial markets rose with stunning speed and power was initially transmitted by a limited amount of ill-advised U.S. housing debt.

**METASTASIS**

Like higher-quality forms of residential debt, sub-prime mortgages were packaged into Residential Mortgage-Backed Securities (RMBS). The prior history of RMBS gave investors some confidence in the safety and soundness of such investments. But the new securities depended on the repayment performance of ‘non-conforming’ loans not eligible for Fannie Mae and Freddie Mac guarantees. They were therefore issued as ‘private label’ securities. Securitization of non-prime housing loans represented an important shift in risk, since non-agency securities carried risks of both prepayment and default. Fannie Mae or Freddie Mac securities were guaranteed against default. From 2000 to 2005 non-agency issuance rose from a 25% market share to approximately 56% of all RMBS. Moreover, the credit quality of these ‘private label’ securities was dropping, with the high-risk sub-prime component growing 20% per year after 2003, and sub-prime pools constituting 80% of non-agency RMBS issuance by 2006. Offshore holdings of U.S. mortgage debt increased fourfold in the fifteen years beginning 1990, and were above $1 trillion at the middle of the present decade.

For investors, the attractions were yield and volume. The amount of money seeking investment grew monumentally after 2000. Anthony Downs, of the Urban Land Institute and the Brookings Institution, identified several sources of increased capital: the economic expansion of China, India, and other Asian nations; changing demographic patterns such as aging populations with impressive accumulated savings; sovereign wealth funds; the startling rise in U.S. corporate profits; arbitrage of the low Japanese lending rate of 1.5% into risk-free U.S. Treasuries at 4.5%; and the rising profits of oil producing countries.

Huge levels of new demand caused rising asset prices and reduced yields. Yet investors of all stripes—pension funds, insurance companies, private equity funds, hedge funds, sovereign wealth funds, banks, mutual funds—clamored for enhanced returns. Securitization, through the bundling of sub-prime mortgages, offered such yields, since the underlying sub-prime mortgages typically yielded 3% more than a prime mortgage loan. Regrettably, that higher yield was not appreciated for its significantly higher risk.

**DISGUISSING AND SELLING RISK**

Securitization disguised risk. The pooling of the mortgages afforded the illusion of diversification. Diversification, the foundation of mod-
mortgage brokers are a highly cost-effective field force for lenders. Brokers were given incentives to originate a large number of deals and to push them toward the highest possible loan amount. This made them behave differently from salaried loan officers.

Is common sense to question how 80% of high risk mortgages, bundled as a security, were rated AAA, and 96% were rated A, AA, or AAA. A relatively new product, the sub-prime RMBS had a thin and recent history of low defaults and rising home values, and the rating agencies modeled the assumption of a roughly 6% default rate. Investors could have resisted that assumption. But who would have? It was in compensation and management fees—to accept a favorable rating for an investment that would boost their overall yield. The credit default swap, AIG was one of the few companies in the U.S. that had an AAA rating, indicating a likely default rate of virtually zero in the eyes of the ratings agencies. Credit default swaps covering securities backed by sub-prime mortgages, were placed under AAA rating, in 1998, and AAA rating—providing investors with the assurance that these very weak-credit mortgage securities would be backed, in the case of default, by AIG’s enormous resources. After September 2008, many were surprised to find that AIG’s primary financial products, which included mortgage securities that the FDIC, the Office of Thrift Supervision (OTS).

In all of this, there was insatiable appetite, a hunger for more, for sub-prime mortgage, private label RMBS, and CDO instruments. The ‘swap’ involves agreement by one party to cover the losses of a counterparty, in the event of default, at a specified rate. A Gordon Credit Default Swap (GDM), which says that the expected price of an asset is equal to its expected yield, divided by its rate of return minus the rate of growth. 

In other words, the higher the expected rate of growth, the greater is the multiplier on income. The marketplace thus favors public and private companies with strong growth potential, rewarding them with higher valuations per unit of income. The imperative of growth is that capital flows to assets with the brightest future. Income growth achieved in three critical ways, all of which played in the housing finance market earlier in this decade: Increasing market size and share, Increasing margins, Increasing price.

Financial institutions booked lucrative fees, from origination of the home loan through the pooling and securitization (loan application fees) through the entire chain of securitizations and derivatives (as each stage in the process involved ‘transaction costs’). These fees improved earnings in the short run, while reducing the burden of holding long-term mortgages in the longer term.

The ability to arbitrage risk in the secondary markets and in derivatives also lowered the cost of funds and improved margins, especially since the total value of the MBS issuance could be higher than the sum of the underlying mortgages. The very existence of robust secondary securities markets reduced the illiquidity premium embedded in the mortgage rate, lowering costs for everyone. Thus, if banks could depend on short-term capital for mortgages with the expectation of selling FICO the secondary market quickly, they could take advantage of the normal shape of the yield curve, where short-term money is cheaper than long-term money. The ability to create off-balance-sheet special purpose vehicles meant that capital reserve requirements could be mitigated, again raising overall margins on measures such as return on assets, since capital freed from regulating obligations could be used to support additional lending.

Consumers learned to play this game shoppers, who were holding onto their savings, shopping for the best available deal. They refinanced frequently as interest rates and housing prices shifted in their favor. They learned that fees could simply be added to the principal amount of the loan and that the required down payment was a negotiable figure. On the business side, the improvement in margins worked through the GDM as presented. The S&P Financials index rose from 372 in May of 2004 to 508 in February 2007, a 37% increase in 33 months. It worked—until it didn’t: by March of 2009, this index was down to 82.

Pricing

One of the classic definitions of inflation (attributed to Milton Friedman) is ‘too much...”

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money chasing too few goods.” Inflation has often been viewed as favoring real estate assets. Housing prices reflect changes in household incomes as well as the impact of the cost of produc-
tion of new homes. The power of leverage, especially higher levels of leverage, enables rather small changes in income or in interest rates to be magnified into much greater changes in home prices. Unfortunately, changes in a negative direction are also magnified by the same process of leverage.

Nevertheless, the separation of asset values from underlying economic fundamentals was identified relatively early, by Robert J. Shiller in 2005, long before the bubble reached its maximum magni-
itude.1 In the world of stocks, the ability to grow earnings based on rising home prices affected a multitude of firms, in housing, in housing-related finance, in retailing, and even in manufacturing. All enjoyed the boom of growth, but all were subject to the conse-
quences of the subsequent bust.

CONCLUSION

Having examined the metastasis of sub-prime mortgage lending the disguising and selling of risk, and the bias toward growth, we have still not fully answered how we arrived at the present sorry condi-
tion.

The recurrence of bubbles over the course of history has been the subject of instructive and entertaining narrative.10 But, as it turned out, this was not merely of historical interest. Many recent events should have been considered warning signs betraying weakness in our financial system. Since 1990, we have had the savings and loan crisis, a related bank capital crisis, and a series of ‘derivatives crises’ associated with the collapse of the Mexican peso in 1995, and of the Thai Baht in 1997, which led to the fall of Long Term Capital Management. Then there was the ‘dot-com’ collapse in 2000 and the shakeout in the telecom industry.

The weakness was clearly not due to a lack of technical skills or analytical capabilities. Nor was it for want of information (although incomplete information did play a role in selling of sub-prime loans to unsophisticated borrowers and the selling of AAA paper to inves-
tors). For at least two decades, the ‘best and brightest’ have flocked to our business schools, and the top graduates have disproportion-
ately gone into the ‘investment industry.’

Our shortcomings have been less due to the quantitative skills in the product) were used in push marketing of mortgages. The customer was ‘pre-qualified’ (even without any previously-indicated interest in the product) were used in push marketing of mortgages.

10. See, for example, the classics, John A. Mackay, Extraordinary Popular Delu-

11. Previous writing on this subject have included, Hugh F. Kelly, “Can Universi-
Before 1999, if homeowners faced foreclosure it was typically due to a life event—medical bills, divorce or unemployment. In the past decade, millions of homeowners have been unable to pay back their mortgage debt because of the terms of the mortgage itself—little or no money down, negative amortization, or rapidly increasing payments. To prevent the fire of exotic loans from burning down the house, we must restore the traditional mortgage to its central role in the housing market.

I work for Neighborhood Housing Services of New York City, part of a national network of 235 nonprofit housing groups chartered by NeighborWorks® America. NHS was founded in 1982 partly as a response to redlining by banks. Our eight offices throughout New York City invested $185 million last year in affordable loans for low-income New Yorkers and educated over 11,000 residents in home buying, home repair, foreclosure prevention, and basic saving and budgeting.

Foreclosure prevention is our fastest growing activity, and the most disheartening. The threat created by aggressive mortgage lending is the greatest NHS has faced since its creation.

The Good Old Days of the Prime Mortgage

The traditional 30-year, fixed-rate, self-amortizing mortgage is a beautiful thing. Invented during the Great Depression, these loans were generally underwritten to standards set by Fannie Mae and later Freddie Mac, government sponsored enterprises (GSEs) that purchased or guaranteed the loans from lenders. While GSEs provided capital to the mortgage market at low cost, they did not generally participate in the exotic mortgage market. Consequently, in recent years, they lost market share to private label securities and their stock prices dropped. According to American Banker, the GSE share of residential mortgage bond issuance fell to a low of 44% in 2007, from 1995 through 2003, their share was in the high 70s and low 80s.

During the decades when the traditional prime mortgage flourished, the typical young family saved for the 20% down payment and closing costs. By their mid-30s, they were ready to buy a house; their family size and income were stable, and they did not expect to move. The bank examined their application using the “5 C’s” of underwriting: credit history, collateral (the value of the home), cash (income), capital (savings in the bank for downpayment) and character (This could be a basis for discrimination, but the banker or broker actually knew the borrower). Purchasers made the same monthly payment for thirty years, providing certainty and stability. Housing costs were fixed and incomes rose over time, increasing the ability to save. At about age 65, the home was paid off and household expenses dropped just as the family transitioned to a fixed-income retirement.

This was the model for working class neighborhoods around the country. Owners lived in their homes until they passed away. Turnover was rare; often the estate sold the home, or it was left to a family member. One street block, in a working class Bronx neighborhood, tells this story. Of its 16 homes built in the 1960s, thirteen had the same ownership from 1966–1986. Four of the owners died in their homes and passed their homes to the children. The affordable fixed payments and high transaction costs associated with moving minimized the turnover of families on the block. Homeownership...
Sub-prime and exotic mortgages of the past ten years are not your parents’ mortgages...basic underwriting no longer protected the borrower or the lender from over-reaching.

Sub-prime and exotic mortgages of the last ten years are not your parents’ mortgages. First and foremost, the mortgages did not conform to GSE standards, so basic underwriting no longer protected the borrower or the lender from over-reaching. Second, the mortgage broker used push-marketing tactics (flyers, phone calls, infomercials) targeted to minorities who distrusted traditional banks with their reputation for saying “no.” I’ve met many families who were told that they were getting a traditional loan when in fact on page 20 of the mortgage document was a rider of an adjustable, negative-amortizing rider. But even this disclosure was opaque; the mortgages typically refer to obscure indices and points, instead of laying out the best- and worst-case payment schedule in simple language. The need to refinance and take money out of the home often coincided with an unexpected illness, divorce, or job loss—traditional reasons for mortgage default. And greed certainly played a part by both borrowers taking cash out of their homes and brokers who earned a commission from loan churning. However, the mortgage terms now magnified the impact. The cash received was often much less than promised, and after commissions and fees were deducted, the refinanced mortgage rarely had terms as favorable as the original one. Parents took on additional jobs to try to keep up with the rising payments. Other household needs—food, medical care, school—were skipped in order to pay the mortgage.

Eventually many families like those on this Bronx block were forced into distress sales. Some couldn’t escape the debt through sale and were forced to decide between foreclosure or bankruptcy. Bankruptcy does not eliminate the debt due on a vided by the 30-year mortgage evaporated, hurting property values, quality of life and the tax base. At the other end of the financial food chain, investors eagerly bought collateralized debt obligations (CDOs) made up of pools of mortgage-backed securities, bundling thousands of Bronx-type loans from all over the country. These investments were much riskier than the investors ever expected.

HELPING OUT A BALLOUT?
Imagine that a homeowner calls 911. Her stove caught fire and she needs help. In stead of getting the address, the dispatcher asks a series of questions: “How did the fire start?” “Was there negligence involved?” Unfortunately, the homeowner was so surprised by the news that she didn’t realize before it dispatches a truck. Its first mission is to put out the fire.

Why is the mortgage crisis so different? The Center for Responsible Lending projects that between 2009 and 2012 more than 9 million families will face foreclosure in addition to 2 million who already lost their homes in 2007 and 2008. Were they all to blame for their difficulties? Is moral indignation really appropriate?

It defines reason and experience that eleven million families knowingly gambled their homes, their children’s stability and their financial security only out of pure greed. Fraud was rampant in the mortgage process, escalating rapidly with the housing boom. Many borrowers did not understand the terms of their loans, and they trusted brokers to find them the best deal. Even the banks and Wall Street funded loans where they trusted the originator or the rating agency. Is misplaced trust a moral hazard, or was it also poor controls, diminished business ethics, and faulty or absent regulation?

REGULATE THE MORTGAGE
First and foremost, trust, confidence and stability must be restored in the mortgage transaction. The borrower needs to know that the mortgage will be suitable for his or her situation. Mortgage brokers should be held at least to the same standard as stock brokers. (Bernie Madoff’s clients are eligible for up to $500,000 from the Securities Investors Protection Corp; no similar fund exists for mortgage victims). Loan terms and documentation should be clear and accessible. The borrower, originator, lender and investor should all retain some responsibility for nonperformance for the entire term of the mortgage. Meaningful relief for victims of fraudulent transactions is needed. Some argue that these steps will make mortgages more difficult to obtain and more expensive. That would be a good thing for the most part: the 9 million at-risk homeowners, many should not have received the loans in the first place. At the same time, underwriting should not be unreasonably restrictive; qualified purchasers should have access to affordable mortgages. Unfortunately, government will not be able to recover. Thoughtful regulation can create the level playing field that will allow the market to better price risk by setting basic ground rules.

REGULATE THE MODIFICATION
Even the minimal regulations governing mortgage origination (Truth in Lending Act, Real Estate Settlement Procedures Act) do not apply to the process used to modify existing loans when a borrower seeks to avoid foreclosure by calling his or her lender or a third party agency. Homeowners are frequently victims of foreclosure rescue scams or of modifications that are worse than the original loan. The Administration’s Making Home Affordable plan starts from the premise of affordability: it cannot result in housing costs exceeding more than 31% of the borrower’s income. But many homeowners won’t qualify for this government program and, unless they have taken the time to go to a reputable counseling service, they may be out of luck. Learn the options available, and definitely do not sign any paperwork with a ‘counselor’ or attorney, they are on their own in the negotiations with the servicer.

CREATE TRUSTWORTHY BORROWERS
You need a Ph.D. in mortgage finance to understand today’s loan terms, and most Americans are woefully uneducated about financing, budgeting and credit. But there are HUD-certified housing agencies and counselors that work with borrowers with a legal obligation to act in the borrower’s interest. Participants in these counseling programs are held to a code of conduct and performance standard different from other counselors. In the wake of the mortgage crisis, many communities have set up financial counseling services with strong consumer protection mandates. In New York City, the city’s Financial Education Initiative (FEI) funds a series of workshops for a total of 235 nonprofit housing organizations and other nonprofit housing groups worked with government and lenders to educate borrowers, transform their savings and credit profiles, and mitigate the risk.

The success of CRA lending is now, unfairly blamed for the mortgage crisis. The Federal Reserve Board has recently studied the performance of loans to low-income,
underrated borrowers under the Community Reinvestment Act, often made in partnership with nonprofit community development institutions. The Federal Reserve study concluded: “Thus, the long-term evidence shows that the CRA has not pushed banks into extending loans that perform out of line with their traditional businesses. Rather, the law has encouraged banks to be aware of lending opportunities in all segments of their local communities as well as to learn how to undertake such lending in a safe and sound manner.” It also “found that loans originated under the CRA program had a lower delinquency rate than sub-prime loans. Surprisingly, the loans in the NWA affordable lending portfolio had an even lower rate of foreclosure than prime loans.” Today we have widespread networks of sophisticated nonprofit lenders who use all five C’s of underwriting in their programs. They are hurt hard by today’s recession, losing access to flexible and affordable capital and charitable support they need to make responsible loans. Both banks and government should invest in these networks to deploy capital responsibly in the neighborhoods that are hardest hit by the mortgage crisis—because it’s a sound business decision to do so.

**CREATE A MEANINGFUL SAFETY NET**

While it is estimated that the Obama Administration’s Making HOMES Affordable program will help 4 million families avoid foreclosure, the program may help less than 50% of the families at risk. During the Great Depression, we wove a strong social safety net for the families that became the Greatest Generation, without calling Social Security or the Home Owners Loan Corporation a bailout. A good model might begin with the New York Times Neediest Subprime Cases Fund, launched last year, which provides basic financial assistance to those who need to move because of mortgage default.

**ENCOURAGE NEIGHBORHOOD-BASED STRATEGIES**

Securitization has complicated efforts to deal with concentrated foreclosures and to stabilize neighborhoods. It is difficult to establish ownership of the loans and of the foreclosed homes, which are scattered through different investment pools and asset management companies. Some investors don’t foreclose, and some borrowers move before foreclosure is completed, leaving ghost properties with titles held in limbo by zombie banks. At a minimum, states need to bring transparency and accuracy to the process of recording lien and foreclosure data, and make public the identities of the managers of foreclosed property and the owners of the mortgage.

We are presently in a crisis that is prompting a dislocation far larger than Hurricane Katrina or the devastation of the South Bronx. Just as a firefighter puts out the fire first and then assesses the cause and the blame, so should our policy makers give us tools to put out the urgent fire, keep families in their homes and resume the flow of responsible credit. There will be time, after the family and the loan are stable, to address the underlying causes of default. The most important ingredients in fire prevention are public education, safety rules in building construction, and a shared commitment to the goal of reducing deaths by fire. Here too, we should unite in our commitment to preventing another mortgage crisis by increasing public education, imposing safety rules, and achieving the goal of a reliable mortgage process.

**NOTES**

1. William M. Rohe, Shannon Van Zandt and George McCarthy, “The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research” (Harvard Joint Center for Housing Studies, Low Income Homeownership Working Papers, October 2001). Donald R. Haurin, T. Parcel, R. Juan Huain: “Does Homeownership Affect Child Outcomes?” (Real Estate Economics, Volume 30, Issue 4, 2002). “We find that owning a home compared with renting leads to a 13 to 23 percent higher quality home environment, greater cognitive ability, and fewer child behavior problems. For children living in owned homes, math achievement is up to nine percent higher, reading achievement is up to seven percent higher, and children’s behavioral problems are one to three percent lower.”


SINCE THE GREAT DEPRESSION the U.S. has developed institutions to control financial crises. Most important has been deposit insurance, and it has worked well. Banks have been able to attract deposits during the Savings and Loan crisis in the 1980s and the stock market crash in 1987.

But insurance provides incentives for risk-taking. Because depositors know they’ll get their money back, they have little incentive to evaluate banks. As a result banks raise money at low rates regardless of their risk, they get the upside, and the insurer takes most of the downside. The Savings and Loan crisis in the 1980s showed both the advantages and disadvantages of this insurance. The S and Ls took too much risk, and many collapsed, but there was limited impact on the rest of economy.

FANNIE MAE, FREDDIE MAC & THE MORTGAGE MARKET

Fannie Mae and Freddie Mac (FF) are best understood within the deposit insurance model. They are government sponsored enterprises (GSEs), but they are not banks. They do not originate loans, and they do not take deposits. Rather, they buy mortgages from commercial banks, savings and loans, and mortgage banks, and they fund them by raising money in capital markets. They do this mostly by securitizing mortgages, which involves pooling them and selling shares in the pools as mortgage-backed securities (MBS). Attached to the pools are FFs’ guarantee to pay investors off in the event of borrower default. They also hold mortgages and MBS on their balance sheets and sell their own debt to fund them. A key to understanding FFs is the perception (not in law) that their MBS and debt are backed by the government, an “implicit” guarantee similar in function and incentives to deposit insurance.

While banks do sell mortgages to FF, their relationship with them is mostly one of competition because FF provide an alternative to the bank model of funding mortgages with insured deposits. When FF buy mortgages they substitute for the traditional bank function of making money by managing credit risk and earning income from the difference between the interest they earn on mortgages and their funding costs, leaving banks with just fee income from originating and servicing loans. This competition has been referred to as “dueling charters.”

The charters have similarities as well as differences. The key similarity is the government guarantee, but there are others. For instance, it has been argued that FFs are problematic because they are neither public (because they are shareholder owned) nor private (because they have public policy objectives), but banks are not much different. While FFs are required to make loans to low income and minority borrowers, banks, via the Community Reinvestment Act, have comparable public purpose goals. The key differences are that FF use their charter to access capital markets, whereas banks have traditionally been largely confined to deposit markets;
Bad as they have been, Fannie and Freddie default rates have been less than half of those of the rest of the industry.

and the two charters have different regulatory structures.4

RECENT HISTORY
Since the 1980s, FF on average have bought about 45% of mortgage originations. (Together with Ginnie Mae, a government agency that securitizes government insured loans, they are referred to as the “Agenc-
ies”.) During the 1980s, especially after 2003, an increasing share of securitization was by “private label” or “non Agency” investment and mortgage banks, packaging mortgag-
es that the Agencies did not or could not securitize. This is the market that promoted the surge in sub-prime mortgages. The banks, FF and the private label institutions all took risks that were not clear to their stakeholders. In the case of FF and banks, their regulators were not able to assess and control risk quickly. In the private label market, it was investors in private label securities who were sold poorly underwrit-

ing structures. 4

MORTGAGE TYPES
Most mortgages are prime or non-prime. Prime loans are higher quality, because of the strength of the buyer, down payment, and underwriting and because of credit enhancements such as mortgage insur-
ance. Non-prime loans lack some or all of these characteristics. They are mostly sub-prime loans, which are loans to bor-
rowers with poor credit and other negatives, or “Alt-A” loans, loans that typically have prime borrower credit history and down payments, but with some flaw, most often low documentation. For the most part FF have stayed in the prime market. Their charters require that they hold “investment quality” mortgages, which excludes sub-prime loans, but not always. Riskier loans are often accepted if they have credit enhancements, such as mortgage insurance, but risk is a matter of degree, and they hold some lower quality mortgages (like Alt-A) without enhance-
ment. FF have also purchased sub-prime (and Alt-A) private label MBSs that were investment quality. Pools of sub-prime loans can have investment quality parts or “tranches” if they are structured prop-
erly, for instance by having subordinated tranches ahead of them in the risk queue. In other words, other investors hold subordi-
nated tranches of the same pool, absorbing losses before the senior, investment quality, tranches take losses.5

FF hold over $6 trillion in mortgage-
backed securities and mortgages. Of this, sub-prime and Alt-A private label securi-
ties, typically purchased from investment banks, are about 4%. These securities were originally highly rated senior tranches of private label MBSs. Many have now been downgraded and would trade at large dis-
terals. They also bought Alt-A mortgages directly as well as some interest-only loans, particularly beginning in 2005. (Some of these were held as investments while others were securitized and sold.) Around 10% of the mortgages held or securitized by both companies are Alt-A. These have been the
costliest and most permissive source. With these loans, banks have incentives to exploit guarantees. The problem is more complicated than guarantees, but we need to control their costs. We cannot avoid the

and investment banks. More recently, the IMF has estimated that overall write-downs from U.S. securities are over $2 trillion, about 20 times the write-downs for Fannie and Freddie.8

SYSTEMIC RISK
Unlike the Savings and Loan crisis in the 1980s, the current crisis has spread around the world. The key difference is that S and Ls were funded almost entirely by insured deposits, so there was little need for deposi-
tors to worry, and there were no banks runs to speak of. That stands in sharp contrast with the complexity of the securitization of non-prime mortgages, which has made it very hard for investors to evaluate both the securities and the health of the institutions that hold them.

Bad as they have been, FF default rates have been less than half of those of the rest of the industry. From the third quarter of 2007 through the fourth quarter of 2008, FF had $119 billion in write-offs as compared to $146 billion for insurance companies and $474 billion for commercial loans. Something similar happened to FF last year as investors were unclear about the willingness of the government to back them up. Conservatorship and the promise of future capital injections have shored up the FF guarantee. As a result FF, despite being on life support, continue to function as an elastic source of funds for mortgages. The rest of the system has become more complicated.

POLICY AND TRADEOFFS
The sine qua non of the Great Depression was the collapse of the banking system, which would not have happened if deposit insurance had been in place. Guarantees are an important stabilizer, but they promote risk-taking. So there is a trade-off. But the problem is more complicated than guaran-
teed institutions. The least guaranteed part of the system, the private label market, took on the most risk. The private label compa-
nies and their insurers have become implicit GSEs. Even without special charters, they were bailed out in an effort to control systemic risk. The underlying problem for both guaranteed and non-guaranteed insti-
tutions is moral hazard. We cannot avoid guarantees, and we should probably not want to; but we need to control their costs.

ALTERNATIVES
Good solutions will have to address moral hazard and the market as a whole. Otherwise risk-taking will simply gravitate to the cheapest and most permissive source. With the demise of the private label market, FF and Ginnie Mae and the banks are all that is left, and there are pluses and minuses for both. Banks tend to have better control over the risks they take because they originate their own loans, as opposed to FF who buy from someone else, however, FF tend to have better access to capital markets (especially for long term funding for fixed rate mortgages) to fund what they buy. Nei-

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nies and their insurers have become implicit GSEs. Even without special charters, they were bailed out in an effort to control systemic risk. The underlying problem for

both is a way of hedging our bets. Fixing one charter and not the other will not decrease moral hazard as much as shift it. Below are proposals for FF after the deal, assuming that the banks are handled similarly.

MAINTAIN PRIVATE OWNERSHIP
In the short run there is little choice but to operate FF as they are: the Agencies are the only game in town. Longer run proposals range from restructing FF as a public utility or as a cooperative, owned by their customers, to folding them into the government, perhaps as a part of Ginnie Mae. These proposals inhibit the flexibility to move with markets. More to the point, they don’t do much about risk-taking: the new FF would either take too much risk, due to political and other pressures, or risk would be shifted to banks. Private ownership leads to more efficient operation, but with it there needs to be control of moral hazard, which is a problem of capital and risk regulation.

MORE AND BETTER CAPITAL
Capital provides a cushion that protects debt holders and guarantors, and it provides incentives to control risk because more investor money is at stake. Before the crisis, regulators applied two capital rules to FF: one was stress tests that simulated company performance under stressful conditions and required that enough capital be held to survive them; the other was a minimum capital requirement that applied if they passed the stress tests. Clearly the minimum was too low. They passed the stress tests, which were tough by historical standards but less stressful than what actually happened. However, simply raising the minimum will not necessarily reduce the risk of failure. FF could ramp up their risk and still be below the minimum. The solution is to make the two tests additive (maintaining a minimum capital requirement plus the capital required by stress tests) so that they will have to hold extra capital for any increase in risk.

Regulators need more flexibility in running stress tests and ability to raise and lower capital levels as the economy changes and for newer business lines. The probability of a stressful event should also be considered in setting capital requirements; passing the stress test in 2007 was not the same thing as passing it in 2001. The later would prevent the capital depletion later.

CONTROLLING FF PORTFOLIOS
FF, like banks, hold portfolios of mortgages and mortgage-backed securities. These have been widely criticized as too risky, but the criticisms have largely been misplaced. The distinction between what is kept in portfolio and what is sold (securitized as MBS) is an accounting, rather than an economic, distinction. FF take default risk on mortgages whether they are held or sold; their current levels of default losses would not have been much different if they had

sold and secured it. The portfolio issue is interest rate risk, a problem that arises when assets and liabilities are mismatched, for instance by funding long term mortgages with short term debt. Interest rate risk is a problem, but the size of the portfolio is not a good measure of interest rate risk for two reasons: a) a very large part of the risk can be controlled, for instance by funding long term mortgages with long term debt; b) and a large amount of risk can be taken in a small portfolio by holding interest rate derivatives. Debt funding has the economic advantage, over MBS, of being attractive to investors who prefer homogeneous assets and would rather not analyze the prepayment risk of mortgages.

There are two ways of handling the portfolios: eliminate them all together, with some exceptions for things too small or too new, or use stress tests to control risk. The latter has been the tool used since the 1990s, and it has worked reasonably well.

EXPLICIT GUARANTEES
 Guarantees should be explicit so that they can be counted on to keep the market open in stressful times. FF, along with banks, should be subject to risk-based “user fees” and capital regulation to control resource misallocation. On top of that, as the private label sector re-emerges we will need a systemic risk regulator, focused on capital adequacy, to handle the risks of institutions that are not explicitly guaranteed but can spread risk and require bailouts anyway.

COMMENTS
Fannie Mae and Freddie Mac have outperformed the rest of the industry in the current crisis, but they will nevertheless need more capital injections if they are to be revived as real businesses. Recent government guarantees to FF have kept the mortgage market going, especially for fixed rate loans, while the private sector has collapsed. The dueling charter model is imperfect, even with updated capital rules, but alternatives, like relying on banks alone or pretending we have a stable, uninsured private sector, are worse bets.

REFERENCES

4. This is quite complicated in practice; the guarantees to deposits can be used indirectly to guarantee other liabilities, as we have seen recently with bank "bailouts," which like the FF bailout have bailed out all sorts of security holders. Differences in regulatory structure have been particularly important in determining capital requirements.
5. Sometimes the structures have default insurance (the infamous Credit Default Swaps). 6. It is not easy to summarize the portfolios of the two GSEs in a brief way. Both companies have web sites with “investor relations” tabs, including power point presentations of their positions and links to publicly available data such as data provided to the SEC. Many of the loan categories shown are overlapping.
7. Sub-prime loans have generally been defined by lender (traditional sub-prime lenders), and more recently by whether they are in a pool classified as sub-prime. Credit score by itself does not make a loan sub-prime.
8. The problem with sorting this out is that the All-A loans, which have had the worst defaults, have also been in the worst places and suffered the worst price declines, so they would have had high default levels in any event.
9. See http://www.fed.org/economics/pubs/gsfa90/090520091025/humphrey.pdf. Note through that while decades almost certainly overstate likely losses for all investments, including FF.
10. A subtle, but nontrivial, benefit of guarantees is that they diminish excessive investment in information about security quality. See Woodward and Hall (2008).
11. For instance, banks can issue “covered bonds,” which are almost the same as securitization, and they can raise short term funds in the deposit market and hedge the risk, which is the same as the GSE portfolio. FF can be allowed to originate loans like banks. More simply, they can require significant recourse from sellers, in the form of reserves set aside until loans have proven themselves, to protect against moral hazard.
12. Special attention does need to be paid to the fact that mortgages have the prepayment option. This can be handled by funding with callable debt, so the debt can be called when the mortgages are prepaid, or with more complicated hedging instruments.
THE NEW PUBLIC INVESTMENT IN RAIL TRANSPORTATION

Congressional support for rail, in particular for Amtrak and for urban transit, has steadily grown in recent decades. But the economic downturn, and the election of Barack Obama and a decidedly pro-rail Vice President, Joseph Biden, have opened a new era of public investment in rail transportation. Railroads, neglected for decades in favor of highways and air, could recapture market share. But the obvious question is how best to spend the money.

Government plans show considerable sophistication, applying an incremental approach that updates a system of regional rail corridors, for the most part on existing routes, allowing eventual operation at speeds between 110 and 150 mph. The only high-speed (over 150 mph) project with initial funding is the proposed California line, supported with last year’s state bond issue. Nevertheless, current initiatives omit several key steps that could improve service nationwide, relatively quickly, and build public support for a system inevitably requiring permanent subsidy. Such projects include electrification of the entire passenger network, provision of light rail services on secondary lines, intense inter-modal coordination with bus lines, and greater attention to the aesthetic environment of rail travel.

RECENT LEGISLATION SIGNIFICANTLY ALTERS SPENDING IN RAIL’S FAVOR

To appreciate the magnitude of the railway funding now proposed, it is useful to first examine the pattern of recent decades. Prior to the passage of the Passenger Rail Investment and Improvement Act in October 2008 (the “PRIIA”), and the Obama Administration’s transportation provisions in the American Recovery and Reinvestment Act of 2009 (the “ARRA”), federal investment in passenger rail was a relatively constant 3% of the total federal outlay for intercity transportation (since the 1970s). A review of the passenger railroad spending of the PRIIA and the combined transportation outlays of the ARRA, including rail, shows that the federal government now plans to devote almost 20% of its 2009 total intercity transportation spending (not including urban transit) to the improvement of rail services.

Amtrak funding, until now the only federal funding for intercity rail transportation, has peaked at just over $1 billion annually in some recent years. For 2009 federal highway spending will reach over $40 billion (state and local spending on highways effectively doubles this amount), and will represent some 76% of the total federal intercity transportation outlay. Pursuant to the ARRA, the federal government is now replacing Amtrak as the least subsidized mode, with roughly the remaining 5%, representing $1.3 billion for spending on airports and other support (apart from the ARRA, there is also the ongoing funding for the Federal Aviation Administration and its critical air traffic control function of about $2.5 billion annually).

The PRIIA initially envisioned $13 billion for rail spending, including the development of intercity rail corridors, and provided approximately $1.3 billion per year for five years for Amtrak. The subsequent ARRA, pursuant to provisions of the PRIIA, authorized $8 billion for the development of new intercity corridors, $7 billion for transit, including rail, and $750 million for transit systems on fixed ‘guideways’ (everything from aerial tramways, buses operating on exclusive rights of way, and high occupancy vehicle (“HOV”) lanes). The bills themselves followed the FY 2008 Appropriations Act, which allocated $30 million to states in matching grants for intercity rail. In addition significant further resources are provided by the Amtrak annual budget, now some $1.3 billion, $10 billion annually to urban mass transit, and the subsidy programs of 13 individual states—California in November 2008 passed an almost $10 billion bond issue for high-speed rail. Other government spending, with passenger transportation applications, such as freight railroad improvements, the enhancement of transportation related structures, and renewable energy research also promise to advance a national network.

Collateral funding sources also benefit passenger rail. Although freight lines have generally not been heavily subsidized by the federal government, ARRA discretionary funds could be used to benefit freight railroads. Most Amtrak services, excepting the Boston-Washington corridor owned outright by Amtrak, share rights-of-way on private freight lines. Accordingly, freight railroad improvements can benefit passenger rail operations as well. The Transportation Enhancement Program, pursuant to the Intermodal Surface

BUILDING A NATIONAL RAIL SYSTEM

John V.N. Philip
Transportation of 1991 (“STEA”), and related provisions of the ARRAs set aside significant funds for a broad range of initiatives "to strengthen the cultural, aesthetic, and environmental aspects of the Nation’s inter-modal public transportation system," including the renovation of historic train stations, landscaping and scenic beautification (specifically the removal of outdoor advertising), and bicycle paths and walking trails. And recent government funding of ongoing research in renewable energy could have broad application across many transportation modes.8

The various appropriations reflect a more truly national perspective on overall transportation policy. At the same time, this spending schema, while vastly more favorable to rail transportation, may still be seen as the keystone of contemporary passenger transportation. Planning a sound overall system still means understanding the car’s preeminent place, while structuring rail and air components9 to meet efficiency, environmental and aesthetic goals.10

GOVERNMENT PLANNING FOR A NATIONAL RAIL CORRIDOR NETWORK
In March 2009, following passage of the PPRAs, the U.S. Government Accountability Office produced a comprehensive study (the "GAO Study"), One month later, shortly after passage of the ARRAs, the Secretary of Transportation issued a special report: Vision for High-Speed Rail in America. (the "High Speed Rail Report"). The GAO Study and the High Speed Rail Report outline current government planning in this area.

Unquestionably, America needs a vastly enhanced passenger rail system, including high speed rail, defined as trains operating at enhanced railroad network, including high speed rail, defined as trains operating at, or above, a maximum speed of approximately 150 mph.11 Japanese, French and German "shinkansen" lines between Tokyo and Osaka, in 1964, operating regularly at a maximum speed of approximately 150 mph,12 France began operating its “Train a Grande Vitesse” (“TGV”) at roughly the same speed in 1981. Both lines now operate considerably faster. While the systems’ development and operational costs are huge and entail constant subsidy, they meet social goals: enhanced safety and efficient transportation choice (including the decrease of highway and airport congestion), boosting economic competitiveness, increasing energy efficiency, encouraging denser “smart growth,” and benefiting environmental quality. However, regional intercity lines, even at lesser speeds, meet most of the same objectives. Transportation policy, now taking shape, correctly proceeds from these assumptions.

Maintaining this policy, especially with the construction costs for high speed lines, will require ongoing public support and funding sources that are independent of recurring legislative authorizations. In France, high speed rail projects have taken 14-16 years to complete. The GAO Study candidly points out that any rail system, in particular a high speed one, will need substantial additional investment, much greater than the recent appropriations, for upgrading and construction as well as operation. While conventional rail passenger systems need permanent subsidy (the experience of Amtrak proving the point), high speed lines, with their heightened maintenance requirements, require more public funding the faster they operate. Japanese, French and German examples, cited in the GAO Study, show that if any high speed lines have covered construction costs, and continual subsidies are assumed. The GAO Study estimates cost per mile for the proposed upgrading of rail lines at $4-11 million. Estimates for high speed rail construction are much higher and generally range from $20-60 million per mile. High speed construction is estimated to cost almost $34 billion from Los Angeles to San Francisco, almost $13 billion from Los Angeles to Las Vegas, and, using a more advanced “maglev” (magnetic levitation) technology,13 some $5.8 billion from Baltimore to Washington (costs for maglev reach about $130 million per mile). While private industry partnerships, bond measures and loan programs may offer some

but as the expense of diesel fuel increases, the operating efficiencies tilt toward electric traction. Such a system can also deliver tremendous reliability in scheduling, a key component of customer satisfaction, along with safety.

Outside of North America, virtually all rail systems in the developed world, conventional and high speed, operate under electric traction. Developing electrically powered corridors could also catalyze the electrification of major suburban lines in urban centers. While Philadelphia and New York14 already operate with such systems, only one other city, Chicago, has even a partial commuter network currently in place. And there are significant economies of scale in using a uniform technology, with components easily obtainable from domestic and foreign suppliers. The environmental benefits of relatively clean energy would be long term.15

The only major caveat is scenic beauty. Even the best engineered catenary system produces visual clutter. Routes of exceptional scenic appeal—for example the New York-Albany corridor, much of the existing West Coast route, the various lines through the Rockies, to name a few—should continue to operate diesel-electric locomotives.

Quick Expansion of the Network to Secondary Lines
A second key policy objective should be expanding the reach of the system to bring rail service, or rail service connections, to many more Americans. A primary way could be by using relatively inexpensive and environmentally unobtrusive self-powered (diesel) light rail vehicles. These would run at average maximum speeds up to 50-60 mph, at subsidized fares, on a wide array of secondary routes. This equipment can be operated singly or in multiple units according to demand, and it adapts to shared rights of way.

Some 32 American cities now have such networks and others are planned. An excellent prototype, the New Jersey Transit “River Line,” shows how such systems can also operate in an ‘interurban’ (the 19th century word for such ‘trolley’ services) context.16 Running between inter-modal terminals with bus and other rail connections at Trenton and Philadelphia, the line serves 18 other communities at attractive suburban stations, operating most days twice an hour, running the historic and scenic route of one of America’s first railroads. Even at these frequencies the vehicles efficiently share street space in several towns with automobile and truck traffic, as well as with the freight trains of private railroads. The cars themselves feature eye-catching picture windows. The one-way fare is $1.93. Construction of such systems can vary from $15 million to the much higher $100 million per mile in congested urban areas, especially where tunneling is required. But service on existing lines, particularly through rural areas, could reasonably be expected to cost in the lower range.

Ease of access for the River Line is provided by the two inter-modal terminals, noted above. Essentially, every station, excepting perhaps overcrowded major urban stations,17 should be reconfigured as inter-modal with connecting long distance...
bus lines and local transit contained within one complex. Boston's
renovated South Station (with its new bus station) and the recently
opened Union Station in St. Louis inter-modal station are excellent examples.
There should be more aggressive efforts to cross-market rail and
bus services, particularly outside urban areas. Rail service
recreation advocates, such as Amtrak's, should sell tickets for bus
connections. Amtrak currently sells its tickets for its own "Amtrak Thruway" bus
lines. But expanded through-ticketing with major operators such as Greyhound could reach a much greater customer base.

THE AESTHETIC IMPERATIVE
Finally, in this nascent phase of a renewed national commitment to
rail, there should be an aesthetic commitment to aesthetics. Further
enhancing the initiatives of the ISTEA legislation noted above. There is no better time to adopt and entice aesthetic criteria for
a national rail system than at the beginning of the bidding process for
specific projects. Such standards should be viewed as an evolving but
permanent feature of future legislation for design and planning of
specific projects and infrastructure. The rail system is a mode of
transportation, a part of city, town, and countryside. It is important to
ensure that this is an aesthetic, pleasing, and sustainable mode of
transportation. The aesthetic aspect of rail design should be
considered in all aspects of the design process from the initial
conception to the final construction. The aesthetic aspect of rail design
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NOTES
1. The $9.95 billion "Safe, Reliably High Speed Passenger Train Bond Act,"
2. The original Act was followed by the "TEA-21" of 1998, and "SAPETEA
of 2005.
org/html/ntech/aesthetics.html. The aesthetic inspiration is profound. "Getting
on the subject of beautification is like picking up a tangled skein of
wool...all the threads are interwoven—recreation and pollution and mental
health, and the crime rate, and rapid transit, and highway beautification, and
the war on poverty, and parks—national, state and local. It is hard to hitch
the conversation into one straight line. Because everything leads to something else." Lady Bird
Johnson, instrumental in promoting the "Highway Beautification Act" of 1965,
writing in her diary on January 27th of that year. PBS "Portrait of a First Lady,
4. The APRRA gives $42 million to the Energy Department for renewable energy
projects. A development such as a viable electric car—or railroad
powered by renewable energy—could impact transportation as astonishingly
as spectacularly as the invention of the internal combustion engine or steam engine. "Deed vs. Do," the Wall Street Journal, April 29, 2009.
5. It is foreseeable that intermodal railways at least for purposes of tourism
could become a factor in the passenger network. albeit relatively small. It
is important that new railway lines carry capacity comparable to that of the nation's intercity camps.
6. In particular, railway railways at least for purposes of tourism,could become a factor in the passenger network. albeit relatively small. It
is important that new railway lines carry capacity comparable to that of the nation's intercity camps.
7. As one example, in December 1935, the Lehigh Valley Transit Co. operated every hour between Philadelphia and Allentown, Pennsylvania, a distance of just over 80 miles, each trip taking about two
hours, making just one intermediate stop. Many coordinated with
centers to other today bus lines, the passengers traveling in an interurbian or
car or railcar and arriving at Penn Station, as well. "Lehigh Valley Transit Co., "Liberty Bell Route," March 5, 1935. "The
Times and the Pacific Electric." (Orange Empire Railway Museum
1983.)
9. An argument often raised against such a proposal in urban centers is the
generally higher population of homeless that traditionally congregate in bus
terminals. But realistic and human solutions, including the provision of soup
kitchens and other aid facilities near the terminals (as is the case at Port Authority
in New York City), can alleviate the issue.
10. As one key example of a potential design, high speed lines are
increasingly widespread, particularly in regions with high population density.

12. "New York presents some special problems in this regard as a majority of the
several hundred electric freight lines that existed in the 1940's (some of which
were electrified) "are inoperable," according to Jeffrey A. Cowen, "Revise
Conventional will be separate. But again, the economies of operation in merging in
a nationwide system would eventually justify real costs.
13. Some of these high rail "revolutions" are occurring electrification, in one case
using electric power and generating and paying for the costs of the energy with the
lease of railroad right of way. Considering this, and also the fact that some of the
same routes are used by Amtrak, the cost sharing possibilities are multiple. "Time
to Revise Electrification" Railway Age (September 2008).
14. The extent of these services in 18th century America was enormous, for
the most part linking cities, large and small to the towns, villages and hamlets along
their lines and delivering clean (electric) transportation to thousands of
communities, many of them bypassed by rail lines. In 1931 interurbans carried
some 44 million passengers per day. As one example, in Depression year 1935,
the Lehigh Valley Transit Co. operated every hour between Philadelphia and Allentown, Pennsylvania, a distance of just over 80 miles, each trip taking about two
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16. Amtrak currently sells tickets for its own "Amtrak Thruway" bus
transportation. A development such as a viable electric car—or rail locomotive—
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hours, making just one intermediate stop. Many coordinated with
centers to other today bus lines, the passengers traveling in an interurbian or
car or railcar and arriving at Penn Station, as well. "Lehigh Valley Transit Co., "Liberty Bell Route," March 5, 1935. "The
Times and the Pacific Electric." (Orange Empire Railway Museum
1983.)

21. There have been few better names chosen for a commission than the
ehypothetic "Idlewild," for New York's largest international airport, named after a golf
course it displaced, recast as today's "JFK."
MANHATTAN’S OFFICE LEASING MARKET: A PANEL DISCUSSION

The following is an abbreviated and edited transcript of a panel discussion on May 8, 2009 at the Ruben Company’s Madison Avenue offices.

SICULAR: I’m the editor of The Stamford Review, and this is a panel on the office leasing market hosted by the Ruben Companies. Our participants are Brian Higgins of Jones Lang LaSalle; Clyde Reetz of CB Richard Ellis; Peter Berti of Cushman & Wakefield; Robert Silver of Newmark Knight Frank; and Bill Elder of the Ruben Companies. Chuck Goldberg of The Pentucket Company is moderating.

GOLDBERG: Gentlemen, thank you. Let’s go around the table. I’d like to know what kind of office space is available today that might have been a rarity one or two years ago.

REETZ: Large blocks of office space. When the market was tighter, there were few large blocks; now we see a much greater number available. The market was driven by those big deals. Anything over a hundred to two hundred, up to 250,000 square feet. Landlords went into other neighborhoods to look for or develop large blocks of space.

BERTI: A tremendous amount of sublease space. The vacancy rates two to two and a half years ago were approaching five percent; now we see a much greater number available. The market was driven by those big deals. Anything over a hundred to two hundred, up to 250,000 square feet. Landlords went into other neighborhoods to look for or develop large blocks of space.

HIGGINS: There’s a much simpler answer: everything is available now. Nothing was available two years ago. You now have a handful, maybe half a dozen buildings, that can generate rents over one hundred dollars. Two years ago there could have been a hundred buildings at that level. Right now that $150 space is $60-dollar space.

SICULAR: What characterizes space, in this market, that rents for over $100 a square foot?

HIGGINS: It’s views, height, ownership and reputation. 375 Park Avenue; 9 West 57th Street.

GOLDBERG: The Seagram Building, the Solow Building.

HIGGINS: The GM Building. But there were buildings down around Bryant Park, at 42nd Street and 6th Avenue and renovated buildings in the garment center that were commanding $100.

SILVER: In the 25 years that I’ve been doing this, I’ve never seen anything go this fast and this deep in such a short period of time. And Brian’s [Higgins’s] right. You know, buildings that were trading in the $125, $140 range are now $60.

ELDER: We all had concerns in the summer of ’07 which did not materially impact the market until September or October of 2008. Since then, the precipitous fall-off has been staggering.
The problem is the debt is at the twelve hundred per square foot level, and the pricing for a purchase today is at the four to five hundred dollar level, so when the loan comes due, you won’t be able to refinance it.

SILVER: One of the things that we see today, that we weren’t seeing, is furnished space. Few tenants looking at space want to spend additional capital for a build-out. And it’s important to point out that a tremendous number of these large blocks are recouping rent and fully furnished, and the furniture’s new and good.

REETZ: The concession packages have also gone up as the base rental rates have dropped. The landlords have to compete. Also gone up as the base rental rates have gone up is the furniture’s new and good. Recently built and fully furnished, and the tremendous number of these large blocks are available space, the number that Peter is describing, includes space that is currently occupied, coming available and currently on the market. And it’s almost a fifteen percent differential.

GOLDBERG: And now the question that every customer and client asks: “When will this market stabilize?”

SILVER: It is our belief that rents will begin to stabilize some time late second quarter or early third quarter and then just be flat for a period of time. I don’t see anything coming back any time soon. The question is when does the bottom hit? In disposing of space, I think the landlords have become patient, despite the fact that many are pushing their agents very, very hard to lease their buildings.

GOLDBERG: In the early 1970s, it was this bad. You couldn’t give space away. The World Trade Center had just come on the market. The Trade Center cut deals at six dollars and fifty cents a square foot. The most you could get for non-World Trade Center space was five fifty. So the entire island of Manhattan tipped towards the Trade Center. Harry Helmsley handed back steam next year, they are not going to lease it, although this is probably the perfect time to do it. We all saw that Boston Properties has finally pulled the plug on the 50th Street Project. So there is a lack of great Class A space coming online, clearly something to be considered. Also there are little glimmers of hope. CBRE took some of the space it was going to sublease at 450 Lexington, they’re going to need that space to do the integration of the Morgan Stanley, Smith Barney merger.

HIGGINS: Bill [Elster], as the only landlord in the room, we have not seen the foreclosure that has been predicted, is there another shoe to drop?

ELDER: Mainly it’s time. Many buildings were financed with floating-rate and short-term debt that is coming to maturity over the next two years. It’s probably somewhere between four and six hundred billion dollars. The Macklowe Portfolio is in terrible distress. Worldwide Plaza and Fifty Forty Broadway are the two latest victims. The John Hancock Tower up in Boston was a victim. The lenders will have to make a decision. We may not see the kind of foreclosure activity that we’re all anticipating because people don’t want to take on the problem. Back in the old days, I think we’d all agree that halfway decent buildings were trading at about twelve hundred dollars a foot. While there are no comps to really justify what the market is today, the general sentiment is probably somewhere between four to five hundred a foot.

REETZ: CBRE investors bought 1540 Broadway for less.

ELDER: For about $360, I think. So, think about the economic run of buying a building at twelve hundred and then having to sell at three-to-five hundred. The conversation that will take place over the next two years is whether the institutions really want to foreclose or whether they want to try to work it out, wipe out some equity or restructure.

SILVAR: Could you talk a bit about what makes a good building and a good landlord?

ELDER: It starts at the front door. How you manage your property’s curbside appeal. How you handle the relationship with your tenant/partners. How you have financed your buildings. Have you done it with low leverage, so you’re not going to lose the building over some short period of time? I think the New York families have a different viewpoint on running real estate than the private equity guys. The RETIs actually do a pretty good job of managing their buildings and managing their relationships with their tenants. They’re not short-term guys. So it’s very qualitative.

BELT: Quality of landlord? Yes, there are names, the Rudin family, the Rubens, but tenants in existing property are one of the best references for a quality landlord. I think what separates the New York families is their ability to make decisions quickly. When you deal with an institution, and they have to go before a committee, or there are guidelines that have to be met, the extended time kills deals. People that will be successful in this
...the game’s changed. Everybody’s represented now. Everybody’s becoming a sophisticated user of real estate.

market will respond quickly, seize opportunities, renew tenants quickly and take a pro-active stance.

GOLDBERG: Let’s talk about the major components of a deal—new building installation, cash contribution, electricity, escalation provisions—how might that have changed over the years? Why don’t we just go around the horn here? Peter, we’ll start with you.

BERTI: There are several components to a deal. The basic ones essentially are a rent abatement and a contribution to work. There was a magical $40 contribution number, which had been around and not moved, for almost 15, 18 years, even though construction costs went from $40 a foot to in excess of $100 a foot for a quality installation.

Right now tenants are unwilling to go out of pocket to build out space. They don’t want to be bothered with it beyond having a plan. Landlords are willing to do that, so it’s costing them more, on the order of $70 a foot. Previously, the rent abatement was essentially construction time. A landlord would give you six months of rent abatement or nine months or eight or twelve months. For a large tenant, it can take twelve months to build space. What people are asking for and getting right now is actual rent abatement after they’re in the space.

GOLDBERG: Peter, how much of that, beyond construction time, is being given on a 5 year deal and a 10 year deal?

BERTI: I would say on a 5 year lease, you are probably looking at anywhere from 4 to 5 months. If you have Mr. Higgins negotiating for you, you might get double that. I would say on a 10 year lease, you’re getting 12 months; although it may be spread out over the term of the lease.

SILVER: I think that these numbers are almost hypothetical because there really is no market right now. There’s so little lease volume, so few deals getting made, the majority of the deals are renewal deals. There are very few deals over say 10,000 feet getting finished, very few.

GOLDBERG: Gentlemen, what are current escalation provisions, how do they differ from what we enjoyed a couple of years ago?

SILVER: During the, the unrealistic days of 06, 07, landlords looked for percent-age increases, even on midtown rents, which was historically the case only in B and C buildings, in midtown south, Chelsea, SoHo, NoHo.

GOLDBERG: And those compounded percentages were?

SILVER: They were between 2.5 and 3 percent. In midtown, the idea was that you wanted to get your rent, but your operating expenses weren’t supposed to be a direct pass-through. The landlord’s philosophy was “I only want my rent, I’m not looking to make money on the operating.” That changed. We saw landlords asking $65–$70–$75, wanting 2.5-3 percent on that, which is like a $2 number per year compounded. What you’re going to see is a movement, especially in midtown, back to more realistic escalations. I think you’re going to get back to more direct operating. In midtown west, it will remain percentage increases but those percentage increases will come down to maybe 2.5 or 2.25 percent.

GOLDBERG: We should say that direct operating means a proportionate share of...

SILVER: Actual operating expenses of the property.

GOLDBERG: Over and above a certain base.

SILVER: In other words, the reimbursement rises with the cost of running the building, but the base rent is fixed for the term of the lease.

GOLDBERG: Correct. And it’s dollar for dollar. It’s transparent. It’s audited.

SILVER: And things were just so crazy in 2007 that landlords were really profiting from the escalation as well. That’s not going to continue.

ELDER: It’s true. It’s going to be a direct pass through, or just to cover whatever costs of the landlord that are increasing. Tenants have gotten pretty sophisticated on what’s an operating expense and what’s not. There are auditable financial statements from the accounting firms that you have to use to prove you’re operating expenses. I don’t see a lot more to the downside to rents. But I think you will see increases in the concession packages. I think you will see landlords willing to spend for tenant improvements, give more free rent, maybe some broker incentives.

SICULAR: There’s a psychological component to the face rent not dropping too low, and they play around with how they handle these concessions?

GOLDBERG: Good point. It’s my un-derstanding that about 85 percent of all transactions in the first quarter of this year were 10,000 sq. ft. or less. Let’s comment upon small businesses being the foundation of a recovery of New York City commerce.

ELDER: I think the actual statistic is that 75 percent of the tenants in New York City are in 10,000 feet and under. However, the flip side is that large tenant users, those who occupy 100,000 feet or greater are, about 50 percent of the market. Most activ-ity is from the smaller tenant, and in past markets they were sometimes a little less sophisticated, sometimes not represented. I think the game’s changed. Everybody’s represented now. Everybody’s becoming a sophisticated user of real estate. The great news is that a lot of these smaller guys aren’t financial firms, or if they are, they are relatively healthy because they spun out of a bank, or they’re a boutique investment bank or a money management firm or whatever that is actually profitable. So thank God for the smaller tenants, because there you will see the activity for the next few quarters, while the large banks figure out what’s going to happen.

HIGGINS: We lag other markets because we have a bigger percent-age of the big users here. When employment starts picking up, you’ll know you’ve not only reached bottom, you’ve bounced off it. Those guys will hire people; then they’ll be out in the marketplace saying I need a place to put them.

BERTI: Politically, we have what is perceived as a very pro-business mayor. I think you can get into a situation where someone can port-ray businesses, and real estate, as greedy people and just hatches away at them. Let’s tax them, and the end result of that is what happened in the seventies, people and companies can vote with their feet by leaving town. So politically, I think that is something that is going to very much effect the outcome.

SILVER: I’m seeing now that people feel that the world is not ending, and they are starting to make more moves, and they feel a little bit more positive about things going forward. Whether it’s the stimulus, or timing, I don’t know. My feeling is that transaction volume will increase tremendously. Unfortunately for landlords, I think there is still going to be a decline in pricing for a time, and then you’re just going to go from flathness for a period of two to three years.

ELDER: I think that’s right. This is not an overnight kind of recovery. You’re going to look back in 4 or 5 years from now and say it was a great time to make a deal. It’s still early, but this is a great time, probably over the next 24 months, to buy real estate. I think that great fortunes will be made in this market.
EATING AT JUBILEE:
NO-NONSENSE FRENCH DISHES
PREPARED FROM QUALITY INGREDIENTS

IT IS TEMPTING to describe Jubilee (347 East 54th Street) as a neighborhood restaurant, but the term neighborhood in New York has been a controversial one for years. One thing that distinguished the East 50s during the generation after World War II were its great French restaurants: Café Chauveron, La Côte Basque, Lafayette, Le pavillon on East 57th Street. These restaurants served classic French cuisine, in chic, fashionable surroundings. Now the only survivor of this halcyon period is La Grenouille on 52nd Street. These restaurants were always for people who didn’t worry about the bill, but there were other restaurants in the area with impeccable French credentials and modest tabs, like La Toque Blanche on 50th Street and Le Moal on Third Avenue.

One thing that characterized these restaurants at dinner was a sense of place. As Annie Cohen and Peter Lehmann explained in their guide, “the people who came here were attached to the neighborhood.” They were a part of the fabric, and the restaurants themselves were a part of the neighborhood. Now the only restaurant left standing nearby, and when she hesitated, two nearby diners said, “Asnières.” One of them added, with mock solemnity, “It’s the final resting place of Rin Tin Tin.”

People return to Jubilee for no-nonsense French dishes prepared from quality ingredients. It serves a French cuisine that used to be called provincial, that is, regional and less complicated than the classic cuisine. The kitchen is remarkably consistent. The menu doesn’t change often, but if you enjoyed a dish here once, you’re likely to find that it’s just as good the second time. A good example is the soupe de poissons ($9.00), a hearty traditional fish broth enriched with cream and served with the traditional garnish of coarsely grated gruyere cheese and rouille (a rich garlic mayonnaise). Jubilee doesn’t always serve the expected croutons any more, but you can use the crusty country white bread that they do serve. Their version of this classic omits the tomatoes you’d expect in the south of France in favor of a north Atlantic version with a creamier broth. (It’s like the difference between the Italian-inspired Manhattan and the New England clam chowders, but Jubilee’s fish soup is in a different class from the latter.) The seasoning is suitably restrained with hints of herbs and a suggestion of saffron. It has the fresh taste of the sea, and it’s very, very good.

Other appetizers include the snails, billed as cassoulette des escargots. You can order either a half-dozen ($10.00) or a dozen ($15.00). They are the traditional snails with garlic and parsley, served in metal casseroles that are hot as fire. Enjoy the scent of the garlic a while before you take a bite. The green salads, either the simple one with organic field greens, dressed with a mild vinaigrette ($8.50), or the fancier one with goat cheese, beets, and basil ($10.00), are generous and fresh. The tuna tartare with ginger and sesame seaweed salad ($14.00) seems a bit exotic among the more traditional dishes, but it’s very tasty.

My favorite entrée is the striped bass ($24.00) described on the menu as “a la plancha,” that is, broiled or baked on a metal plate. Fortunately it’s served on a regular dinner plate with artichoke hearts and zucchini. The bass is seared on the outside to perfection, and the inside is moist and flavorful. I sometimes go to Jubilee resolved to order a different entrée and then have this one. It’s one of the best fish dishes in town. In fact all of the fish and seafood entrees at Jubilee are fresh and well-prepared. For the summer menu, Jubilee removes the broiled salmon served on a bed of lentils ($22.00) and, for the same price, substitutes cold poached salmon with tabouli and asparagus in basil lemon sauce. (For me this is an improvement, since I tend to associate lentils with andouille or some other sausage.) Sometimes there’ll be a seasonal seafood specialty, like soft-shelled crabs, available for “market price.” If price is a concern and you like mussels, you can order a big bucket of them served with either French fries or salad for $20. The steamed mussels come in three versions: traditional marinieres, curry-flavored, or the general favorite, poulette—in chicken broth with cream, mushrooms, chives and asparagus. My favorite entrée is the striped bass...I sometimes go to Jubilee resolved to order a different entrée and then have this one. It’s one of the best fish dishes in town.
and white truffle oil. This preparation raises the humble mussel to something rather extraordinary.

Like many other restaurants in Manhattan, Jubilee now offers a prix fixe meal ($30.00) at lunch or dinner which includes appetizer, main course, and dessert. Unless there’s something on the prix fixe that you really want, it’s probably better to order an entree and either an appetizer or dessert from the a la carte selections. But I guess this is always the case.

The meat dishes are also consistently fine. The steak frites in green pepper sauce ($28.50) is reliable and cooked to order. The rack of lamb ($30.00) is the most expensive entrée. It’s really good, though, and the gravy on potatoes that accompany it is terrific. I think almost everyone is tired of chicken, but Jubilee’s roasted organic chicken breast with garlic mashed potatoes ($23.50) may revive your interest. The steak tartare is served with both French fries and salad, and at $24.00 is one of the bargains on the menu. It’s highly seasoned (but not spicy), so if you like your raw chopped beef au naturel, this one’s not for you.

Desserts include the inevitable chocolate cake, warm apple tarte with vanilla ice cream, and great profiteroles with chocolate sauce. There’s also an elegant granité of raspberries. Prices range from $7.00 for ice cream or sorbets to $9.00 for the more interesting desserts.

The wine list is a bit pricey, but you can have a very good Muscadet for $29 to go with the seafood dishes. As for the red wines, a top Boury (Chateau des Tours) will run $41, but a very acceptable Cote de Rhone is $32. Bottles get more expensive when you venture into the Burgundies.

If you go to Jubilee regularly, you see the same people often, obviously happy to be there, nodding to familiar faces around the dining room and ordering their favorite dishes. One thing Jubilee doesn’t have is plenty of space between tables, and most of the seating is at banquette tables. This means that you’ll be dining in pretty tight quarters. Fortunately, the people at neighboring tables are very considerate, as one would expect. Jubilee is not exclusive in any way, but it’s necessary to call early and get a reservation. If you show up without one, you may get a table, but the chances are you’ll wait for quite a while.

Dedicated to the Sale of Prominent Residences over $5m

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