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MORTGAGE REVENUE BONDS

Revised 10/09/80

Sacramento City Council
Sacramento County Board of Supervisors

Honorable Members In Session:

SUBJECT: Mortgage Revenue Bonds

SUMMARY

The attached report updates progress on the City/County Mortgage Revenue Bond issue and makes certain recommendations for Board of Supervisors and City Council action and procedure toward completion of the project.

The report also includes information on:

- Sizing of the bond issue,
- Buyer eligibility criteria,
- Issuance expenses,
- Underwriter and bond counsel costs,
- Selection and payment of trustee and administration,
- Selection and payment for mortgage loan origination and servicing,
- Developer selection,
- Program administration,
- Arbitrage income,
- Geographical distribution of mortgages.

RECOMMENDATIONS

It is recommended that the Board of Supervisors and City Council:

1. Direct that the project be abandoned if developer interest, as evidenced by the posting of commitment fees, does not support a minimum issue size of $25,000,000.00.

2. Establish a pricing committee composed of the County Executive, City Manager, and Executive Director of the Housing and Redevelopment Agency or their designees responsible for securing a rating for the bonds and evaluating underwriter bids.

3. Abandon the issue if the interest rate on mortgage revenue bonds reaches 11 percent or more prior to our sale date.

4. Accept the underwriter's bid only if bonds can be sold at a price which allows mortgage issuance to house buyers at least two percentage points below the prevailing interest rates, or if, in the judgment of the pricing committee, the rates bid are non-competitive.

5. Exclude substantial rehabilitation from the portion of the bond proceeds which must be used for new construction or substantial rehabilitation.

6. Adopt the attached resolutions authorizing the expenditure of up to $5,000 ($2,500 each for the City and County) in Community Development Block Grant funds for 'out-of-pocket' bond counsel's expense.

7. Select the firm of Orrick, Herrington and Sutcliffe as bond counsel.

8. Approve the cost of issuance, underwriter's, bond counsel's, and other miscellaneous fees described in the report.

9. Inform participating developers and loan originator/servicers that there can be no guarantees that any commitment fees will be returned even if the bond issue is sold.

10. Authorize up to $50,000 annually, initially from bond proceeds, and subsequently from Reserve Account Income to cover local administration of the program.

11. Assign the Housing and Redevelopment Agency as the Internal Administrator of the program for the duration of the bond issue.

12. Agree to place all excess program income into a contingency reserve for housing programs having City/County benefit.

13. Make no formal allocation between incorporated versus unincorporated area mortgages.

14. Direct staff to make every effort to insure equitable City/County distribution consistent with developer and mortgage banker interest.

Respectfully submitted,

Mac Mailes
Assistant City Manager
for Community Development

Gary Cassady
Administrator
Administration and Finance Agency

Recommendation Approved:

William H. Edgar

GV Walter J. Slipe
City Manager

Brian H. Richter
County Executive

cc: Community Development Block Grant Program

REPORT

ON

MORTGAGE REVENUE BONDS

BACKGROUND:

On September 2, 1980, staff was directed to proceed with the necessary preparations for the bond issue and to report back with specific details as appropriate. Staff has met with the managing underwriter (Blythe, Eastman, Paine, Webber, Inc.) and has selected and met with bond counsel (Orrick, Herrington and Sutcliffe) in order to determine the issue specifics. The purpose of this report is to present you with those specifics at an early stage so that your concerns can be addressed.

As you will recall, the program is designed to provide mortgage money to low- and moderate-income persons throughout the City and County. Bonds will be sold in the County's name but will be legally backed only by mortgage revenues. There is no financial liability to either the City or the County. According to State law, however, at least 60 percent of the proceeds of such a bond issue must be used for either new construction or substantial rehabilitation. The remainder can be used to finance existing homes. The size of the issue is thus dictated by the amount of new construction and/or substantial rehabilitation to be undertaken.

Economies of scale require a minimum issue size of approximately $25,000,000.00. All of the mortgages on new homes can be made to families earning up to 120 percent of the greater of Statewide, County, or Standard Metropolitan Statistical Area (SMSA) median household income (currently approximately $28,000 per year for a family of four). For existing homes, 50 percent of the mortgages can be made to families earning 100 percent or less of median income (approximately $23,000), however, the other 50 percent must be made to persons earning

80 percent of median (approximately $19,000) or less although this may be raised to 90 percent (approximately $21,000) upon a finding by the local government that there are insufficient numbers of credit worthy persons whose income does not exceed 80 percent of median household income. We may report back with a recommendation in this area at a future date.

Based upon information from both bond counsel and the underwriters concerning the complexities of qualifying substantial rehabilitation as part of the 60 percent new construction quota, we do not plan on making it a part of this program. (NOTE: The City, County, and Sacramento Housing and Redevelopment Agency emphasize rehabilitation in their local Community Development Block Grant and California Housing Finance Agency [State] Home Ownership and Home Improvement [HOHI] programs.)

Additionally, based on advice of the underwriting group, it would not be advisable to proceed with an issue of this nature unless mortgages would be offered at a percentage rate which was at least two percentage points below prevailing conventional rates, in order to provide some assurance that our mortgages will remain competitive to participants during the ensuing year. Further, the underwriting group has advised of the risks involved with the program should the general level of conventional rates fall below our rates subsequent to our bond sale date. Specifically, if mortgages cannot be made the bonds sold may have to be called and commitment fees lost. This, of course, is an inherent risk in the program. Again, there is no risk or obligation on the part of either the City or the County.

You should also be aware that there are several other significant 'ifs' inherent to this program, among which are the following:

1. Developer interest;
2. Originator/servicer interest;
3. Federal legislation continuing tax exempt status of the bonds;
4. Prevailing interest rates on bond sale day.

We will keep you informed on these developments as they occur. However, if all goes well and none of the abort points mentioned become realities we will proceed with the issue based on your action today.

<u>SPECIFIC ISSUES</u>:

Considering this background information and assuming that we are still proceeding with the issue, the following is an itemization of the steps in the process, local options, if any, and expenses involved along with a recommendation, if appropriate, on how to proceed with that step. It should be noted that dollar and percentage figures quoted are <u>estimates</u> of the final figures to be agreed upon, some of which cannot be set <u>until</u> the date of bond sale. Again, we have attempted to present a 'worst case' (i.e., most expensive) example and will negotiate better terms in each individual instance if possible.

* * *

Item: ISSUANCE EXPENSES

Fees paid pursuant to the issue can be broken down into two categories: Cost of Issuance and Underwriter's Discount--as indicated below:

COST OF ISSUANCE

Expenses directly attributed to the issuer and paid out of bond proceeds typically include: printing of the bond indenture and preliminary official statement (o.s.); printing of the bonds; rating agency fees and feasibility consultant fees. Assuming a $100,000,000 issue, these costs may range as follows:

Printing of indenture and preliminary o.s.	$35,000 - 55,000
Printing of bonds	$10,000 - 15,000
Rating agencies	$10,000 - 20,000
Feasibility consultant	$20,000 - 30,000
TOTAL	$75,000 - 120,000

UNDERWRITER'S DISCOUNT

The underwriter's discount is quoted as a "gross spread" in dollars per thousand dollars of bond issued. This gross spread is broken down into four components: management fee, expenses, underwriting risk, and 'takedown' or sales commission.

Management fee is determined by a variety of factors including the size of the issue, the number of co-managers, the complexity of the issue, the possibility of future issues, and the amount of time spent developing the issue. Assuming a $100,000,000 issue, with three managers sharing the fee, and little possibility of a subsequent issue, the management fee may range between $4.50 to $5.50 per $1,000 of bonds issued.

Expenses typically include: printing of the underwriting documents; printing of the final official statement; advertising expenses incurred in offering the bonds; underwriter's counsel fees; computer time; out-of-pocket expenses; clearance fees and any costs incurred in offering and distributing the bonds. Expenses for a relatively straightforward $100,000,000 housing issue may range between $1.00 to $2.00 per $1,000.

Underwriting risk is determined by the bond credit rating and the underwriting syndicate's perception of the bond's marketability. Underwriting risk for this issue may be $3.00 to $4.00 per $1,000.

Takedown or sales commission is determined by a number of factors including bond credit rating, marketability, activity among investors in the bond market and the takedowns available on competing bond issues. In today's market average takedown on A/A rated local housing issues are ranging between $25.00 and $35.00 per $1,000.

We have looked at some other recent issues of a similar nature (see below) and find these rates to be comparable.

Issuer	Lancaster, CA	Pomona, CA	Orange County, CA
Size	$39,280,000	$100,000,000	$100,000,000
Rating	/A	/A	A/A+
Type of issue	SB 99	SB 99	AB 1355
Complexity of issue	Complex	Complex	Very Complex
Market conditions	Very Difficult	Difficult	Difficult
Possibility of 2nd issue	Probable	Yes	Possible
Sale date	03/06/80	08/22/80	08/13/80
Cost of issuance	$682,680	$779,000	$500,310
Gross spread	$35.50	$35.50	$27.41
Management fee	$4.00	$4.70	$4.00
Expenses	$3.50	$1.70	$1.91
Underwriting risk	$2.00	$1.75	$1.50
Average takedown	$26.00	$27.35	$20.00

Item: BOND COUNSEL'S EXPENSES

Bond counsel's fees will be calculated upon the principal amount of bonds of each series issued and will be as follows: one percent of the first one million dollars in principal amount of bonds, plus one-half of one percent of the next four million dollars in principal amount of bonds, plus one-fifth of one percent of the next five million dollars in principal amount of bonds, plus one-tenth of one percent of the principal amount of bonds in excess of ten million dollars, subject to a minimum fee of twenty-five thousand dollars for such series.

We have compared these fees with the fees charged on similar issues and they are comparable. Bond counsel's services are imperative to the success of the issue and include an in-depth look at all legal aspects of the issue. The most important service they provide is an opinion that the issue will be tax exempt. All of the counsel's expenses will be derived from the proceeds of the issue except the pre-issue out-of-pocket expenses outlined below. Those will not exceed $5,000. We recommend funding them from CDBG funds on an equal City/County basis. (Bond counsel's out-of-pocket expenses include direct travel and other miscellaneous expenses which accrue to the firm prior to bond issuance but do not include charges for time and consultation.)

Item: SELECTION OF THE TRUSTEE/ADMINISTRATOR & RELATED FEES & EXPENSES

The trustee is the agent appointed to protect the interests of the bond holders. The trustee is responsible for collecting the funds paid in from the various originator/servicers, for paying interest to the bond holders on a timely basis and for retiring the issue on schedule. The trustee is also responsible for investing bond reserves on behalf of the bond account and for insuring that participating lending institutions are following the program guidelines. Selection of the trustee is customarily done by the underwriting group. Usually it is one of the larger nationwide banking institutions. Their fees are fairly standard and are derived from initial bond proceeds and the spread between the bond payment rate and the mortgage rate.

Trustee's Fees: $10,000 - $15,000 from initial proceeds and 0.130 percent of the interest rate yearly.

Item: SELECTION OF & FEES PAID TO PARTICIPATING ORIGINATOR/SERVICERS

The loan originator/servicers are those local banking and mortgage institutions who wish to participate in the program as mortgage makers. Selection will be by open invitation, however, if we get a large number of applicants we may want to limit the number of servicers. They will deal with developers and/or individuals interested in obtaining mortgage money under the program. Invitations to participate will be held on an open and competitive basis. For existing mortgages, commitment fees of approximately four points (e.g., two in cash and two in a letter of credit) will be required which may be used to pay bond costs while mortgages are being made. Some of these fees may be refundable. Typically, the letter of credit will not be used if mortgages are made on time.

Fees for services rendered by originator/servicers will be paid by the home buyers as part of the mortgage cost and from the spread between the bond payment rate and the mortgage rate. Fees for mortgage insurance are generally considered along with servicer's fees.

Originator/Servicer Fees:	0.300 percent yearly
Insurance:	0.120 percent yearly

Item: PARTICIPATING DEVELOPER SELECTION

All local developers shall be eligible for participation in the program. The Sacramento Building Industry Association members have been notified and other reasonable efforts made to notify builders of program availability. Selection of participating builders will be dependent upon three factors:

1. Established ability to construct acceptable housing.
2. Evidence of project readiness--i.e., project must be far enough along so that mortgages can be made in calendar 1981.
3. Ability to post a commitment fee of approximately two percent (points) of the dollar amount requested and to provide a letter of credit for additional points requested (probably two to three).

Upon completion of making all mortgages, excess commitment fees not required for bond security, if any, may be returned to the developers and originator/servicers. It is fairly certain that points required in cash will not be returned, however, every effort will be excercised not to use the letters of credit. The recommendation is that developers and originator/servicers should be advised that as of this time no fees, cash, or credit can be guaranteed to be returned, and that the issue will be reconsidered at a later date. This, of course, does not apply if the issue is not sold, in which case all fees would be returned.

Item: LOCAL PROGRAM ADMINISTRATION

The County Executive's and City Manager's Offices will jointly provide staffing for the program until bond sale date. The reason for this is that the demand upon staff time and attention to the program is so intense during this interval that it is not felt that the Housing Authority has the necessary staff time available. After the sale, however, the Housing Authority will serve as the Internal Administrator of the program and will issue periodic reports concerning progress on making mortgages, status of the bond account, and other related matters. It will also be necessary to check periodically to insure that the banks involved are following the overall program guidelines. The recommendation is to commit up to $50,000 annually in bond revenue from the spread between the bond payment rate and the mortgage rate to finance a position within the Housing Authority for the purpose of ongoing monitoring of the program. The incumbent to that position could also be responsible for analysis of future legislation concerning mortgage revenue bonds and could serve to advise both the City and County on future issues. It would be assumed that the Housing Authority would take the lead role on any future issues including coordination during the financing phase.

NOTE: Table 1 (attached) provides a tabular breakdown of all prospective expenses involved.

Item: PROGRAM INCOME

It is probable that via arbitrage (the ability to earn investment income on reserves which is greater than bond interest cost) on the reserve account and through other miscellaneous income accruing to the bond account, excess funds may accrue to it which would be revenue to the County. While the amount, if any, is impossible to estimate because of the uncertainties of future arbitrage, total cost of the issue, subsequent resale of homes, etc., it is recommended that these funds be placed in a contingency reserve account which would be available for housing related programs of value to both the City and the unincorporated County areas. Further, any monies remaining in the bond principal and/or interest account after all bonds have been called or redeemed should be transferred to this account.

Item: CITY-COUNTY MORTGAGE DISTRIBUTION

The issue of whether the City or the County would get a 'fair share' of the mortgage funds has been raised. The recommendation is that if commitments for new construction do not reflect a fair distribution, that every attempt then be made to select mortgage bankers for the 'existing' portion who work primarily within the City or County in an attempt to even the distribution, but that no formal split be made. The reason for this is simply that the strength of the issue is reliant upon the size of the mortgage market area. Any artificial constraints on this could affect the appeal of the issue to prospective bond buyers.

Item: SCHEDULE OF EVENTS

OCTOBER 1 - Meeting with developers to discuss program (complete)
6 - Tentative commitments due from developers ($93,000,000+)
8 - Commitments reviewed--Approximate issue size determined--Commitment fees solicited (FIRST ABORT POINT)
8 - Letter soliciting interest mailed to mortgage bankers and other potential originator/servicers
14 - Meeting with originator/servicers
20 - Tentative commitments from originator/servicers
31 - Draft bond prospectus ('red herring') published

NOVEMBER 1 through DECEMBER 31

- Response to 'red herring' analyzed
- State review committee hearings
- Bonds rated
- Final prospectus published
- Bond sale (SECOND ABORT POINT)

CALENDAR YEAR 1981

- Mortgages made

JANUARY 1, 1982 through JUNE 30, 1982

- Excess bonds (if any) called

CALENDAR YEAR 1982 and BEYOND

- Mortgages paid
- Bond holders paid
- Account managed
- Revenues (if any) accrue to special purpose reserve account.

TABLE 1

USE OF BOND PROCEEDS
AND EXPLANATION OF INTEREST RATE SPREAD

For a typical Single-Family Bond Issue, the proceeds would be applied to the following uses:

- Mortgage Loan Funds		83 %
- Reserve Account for Debt Service		12 %
- Costs of Issue:		
Underwriter - Cost of Issuance Fees	0.12 %	
- Discount Fees	4.65 %	
Bond Counsel	0.13 %	
Local Administration	0.05 %	
Trustee	0.015 %	
- Total Costs of Issue (rounded)		5 %
Grand Total		100 %

On a hypothetical $100,000,000.00 issue, this would result in $95,000,000 of assets and $100,000,000 of bonds. The $95,000,000 must be invested at a rate which is sufficiently greater than the bond rate to pay the interest on this $5,000,000 of what are called, by the industry, "non-asset bonds".

In addition to paying off the non-asset bonds, the interest rate differential between the bond interest rate and the mortgage interest rate must also be sufficient to pay for servicing of the loans, insurance, administration, and the trustee.

A typical spread between the bond rate and the mortgage rate would be 1 percent or 100 basis points and would be allocated to the following purposes:

Purpose	Percentage
Servicing	0.300 %
Insurance	0.120 %
Local Administration	0.050 %
Trustee/Administrator	0.130 %
Non-Asset Bonds (Principal & Interest)	0.400 %
TOTAL	1.000 %

This means, for example, that a bond rate of 10-1/2 percent would produce a mortgage rate of 11-1/2 percent. The initial 10-1/2 percent will be used to pay interest on the bonds with the 1 percent covering the items mentioned above. All this works out without any difficulty except under certain conditions. Two such would be (1) that no or very few loans are made, and (2) that loans made are prepaid rapidly.

In either case, the total dollar amount received or earned by the mortgage portfolio will be below that expected and probably will not be sufficient to pay off all the non-asset bonds. This occurs because the bulk of the cash is not invested in the mortgage loans or is invested for too short a time period. Furthermore, because the loans will not be purchased immediately, the issuer will have to invest until lenders have originated loans and are prepared to sell them.

Today's bond interest rates are higher than current short-term investment yields. This produces a short-term holding period deficit. This adds to the amount of non-asset bonds because you must use proceeds that would otherwise be used to make mortgage loans to pay interest on the bonds. To overcome this predicament, it is necessary to ask lenders to put up commitment fees to participate in the program, a part of which would only be reimbursed if loans are made. If loans are not made, this commitment fee money will be used to pay non-asset bonds. If loans are made, a portion of the commitment fee is still kept, improving the asset liability situation, which is important in the situation where loans made are prepaid rapidly.

RESOLUTION NO. 80-685

Adopted by The Sacramento City Council on date of

RESOLUTION TO ALLOCATE UP TO $2,500 IN COMMUNITY DEVELOPMENT BLOCK GRANT FUNDS FOR THE PURPOSE OF PAYING BOND COUNSEL'S OUT-OF-POCKET EXPENSES RELATED TO THE CITY/COUNTY COLLABORATIVE MORTGAGE REVENUE BOND ISSUE

BE IT RESOLVED BY THE COUNCIL OF THE CITY OF SACRAMENTO AS FOLLOWS:

1. That the City Council hereby declares its intent to collaborate with the County of Sacramento in the issuance of home ownership mortgage revenue bonds pursuant to Part 5 of Division 31 (Section 52000 et seq.) of the California Health and Safety Code, and to take all actions legally necessary to do so, provided that such bond issue is determined by this Council to be feasible. Nothing herein shall be construed to obligate the City Council to issue or collaborate in the issuance of said bonds.

2. That the firm of Orrick, Herrington and Sutcliffe has been selected as bond counsel for said bond issue and that there is a need to reimburse them for minor out-of-pocket expenses regardless of whether the issue sells.

3. That the City Council hereby agrees to expend up to $2,500 in Community Development Block Grant funds for this purpose.

MAYOR

ATTEST:

CITY CLERK

RESOLUTION NO. ____________

RESOLUTION TO ALLOCATE UP TO $2,500 IN COMMUNITY DEVELOPMENT BLOCK GRANT FUNDS FOR THE PURPOSE OF PAYING BOND COUNSEL'S OUT-OF-POCKET EXPENSES RELATED TO THE CITY/COUNTY COLLABORATIVE MORTGAGE REVENUE BOND ISSUE

BE IT RESOLVED BY THE BOARD OF SUPERVISORS OF THE COUNTY OF SACRAMENTO AS FOLLOWS:

1. That the Board of Supervisors hereby declares its intent to collaborate with the City of Sacramento in the issuance of home ownership mortgage revenue bonds pursuant to Part 5 of Division 31 (Section 52000 et seq.) of the California Health and Safety Code, and to take all actions legally necessary to do so, provided that such bond issue is determined by this Board to be feasible. Nothing herein shall be construed to obligate this Board to issue or collaborate in the issuance of said bonds.

2. That the firm of Orrick, Herrington and Sutcliffe has been selected as bond counsel for said bond issue and that there is a need to reimburse them for minor out-of-pocket expenses regardless of whether the issue sells.

3. That this Board hereby agrees to expend up to $2,500 in Community Development Block Grant funds for this purpose.

On a motion by Supervisor ____________, seconded by Supervisor ___________, the foregoing resolution was passed and adopted by the Board of Supervisors of the County of Sacramento, State of California, this ______ day of ____________, 1980, by the following vote, to wit:

AYES : Supervisors,

NOES : Supervisors,

ABSENT: Supervisors,

____
Chairman of the Board of Supervisors
of Sacramento County, California

(SEAL)
ATTEST: ______________________________
Clerk of the Board