Memorandum

TO: John A. Bell, Associate General Counsel for Metropolitan Development

FROM: Victor J. Pettit

DATE: November 21, 1969

SUBJECT: Proposal for Combining New Community Obligations

Pursuant to a request by Ivan Maitus, I have reviewed the proposal dated September 16, 1969, submitted by The First Boston Corporation in respect to a possible method for providing private market financing for the new communities program.

Basically, The First Boston Corporation suggests that the most acceptable method for financing the new communities program would be through a "pooling" of new communities obligations by the Government. Under the proposal, individual developers would be given a "line of credit" each year. The aggregate money needs of all developers involved in the program would be financed by public sale of a single type of obligation issued by a trustee and sold on the private market. Obviously, the obligations would be secured by the full faith and credit of the United States and, in all likelihood, an entity such as HUD, FNMA, or GNMA, would be designated as the trustee.

My overall reaction to the proposal is favorable. However, of necessity, the proposal was very broad and general. In order that it may be intelligently evaluated, a great deal of additional thought must be given to the way in which the proposed financing operation would be administered, particularly in respect to several basic matters. For example, a major problem would be one of scheduling private market sales to coincide with the developers' money needs. This involves a determination as to the number and timing of public sales and is extremely difficult due to the uncertainty of the developers' periodic cash needs and income projections which are always subject to substantial fluctuations caused by both changes in the money and real estate markets and the nature of the many and varied problems which can be encountered in the development of each individual new community. Although I agree with The First Boston Corporation that straight maturities without a sinking fund would probably be an attractive instrument in the money market, careful consideration must be given to the proper maturities for such obligations. Although The First Boston Corporation recommended use of 3-5 year and 20-25 year maturities, there may be good reasons for going to very short maturities during a given period or to extending maturities during periods when longer-term paper has appeal. In any event, straight maturities without a sinking fund would have the same characteristics as government agency paper and would appear to me to
be the easiest kind of obligation to market. In respect to both scheduling and maturities, I suggest that the most important thing to remember is that it is advisable to establish a system which provides some degree of flexibility so that as conditions change, the private market financing operations can be appropriately adjusted.

Another major factor which requires a great deal more consideration is the manner in which the obligations would be marketed. It is extremely important to develop a broad secondary market which will provide liquidity and order to financing for the new communities program. This requires an initial program of market education and continuing attention to maintaining the secondary market. Obviously, there are several ways in which the marketing could be handled. For example, if the total amount of money involved is fairly small by money market standards, the appointment of an exclusive distributor might be considered. However, if the amount involved will be relatively large, than the designation of an underwriting syndicate composed of several major financial institutions might be more advisable. Without question, this matter must be given more consideration.

I realize that if it is ultimately determined that fundamental changes must be made in the program in order to provide private market financing on the most reasonable terms, further legislation may be needed. However, I suggest that it is preferable to obtain such legislation now and provide a firm foundation for the financing of the program rather than establish a "makeshift" or "patchwork" financing arrangement which will not properly serve the long-term interests of the program.

As I suggested to you in our recent telephone conversation, several proposals were submitted earlier this year by various investment banking institutions in respect to private market financing for the college housing program. I believe that a great deal of the discussion contained in these proposals would be of value to you in considering the manner in which to best handle private market financing for the new communities program. I would particularly recommend that you examine the following:

Proposal of The First Boston Corporation dated March 6, 1969—This proposal suggests that the Secretary of Housing and Urban Development make direct loans to colleges and then finance such loans by selling obligations backed by the full faith and credit of the United States Government.

Proposal of Merrill Lynch, Pierce, Fenner & Smith and Salomon & Hutzler dated March 20, 1969—This proposal suggests the creation of a trust into which educational institutions would deposit their obligations, payable to the trustee. The trustee would then sell to the public securities based on such obligations. The proceeds from the sale of the securities would be turned over to the educational institutions which deposited obligations into the trust.
Proposal of A. G. Becker & Company dated April 2, 1969—This proposal recommends that HUD should be the marketing agent for private colleges and should sell short-term securities to obtain the necessary funds to finance housing for such colleges.

As I previously indicated to you, a great deal of effort was expended in discussing the various possibilities for college housing financing with representatives of commercial banks, investment banks, and interested law firms. This effort was spearheaded by Israel Rafkind, who is on the staff of the Deputy Under Secretary, and involved discussions in both the Midwest and New York City. I am sure that Mr. Rafkind could furnish copies of the aforementioned proposals as well as other materials which would be helpful in your analysis. However, if needed, I also have copies of the proposals. In my opinion, the three proposals contain an excellent discussion of such matters as the advantages of short-term financing, distribution of securities, selection of maturities, and use of a sinking fund.

I also wish to comment on the point made by Ivan Meitus in his memorandum to you dated November 10, 1969. Ivan indicated that perhaps banks and investment firms would find it easier to distribute obligations of "better known" new communities projects. If this was the case, he felt that the proposal of The First Boston Corporation "might serve to even out the rate at a significant cost increase to a better thought-of project." In my opinion, all of the developers participating in a pooled funding arrangement with a single type of Federally-secured obligation being sold by a Federal entity acting as a trustee would benefit from the arrangement. I am confident that the interest cost to all developers would be below that which they would incur if they sold their own obligations on the private market in separate public sales, even though such obligations were guaranteed by the Government. As indicated by The First Boston Corporation, its proposal would preclude fragmentation of the market for new communities obligations and would help to establish a sound secondary market for such obligations. In addition, it is very likely, particularly under the rather chaotic market conditions we are presently experiencing, that relatively unknown or small developers would find it impossible to place their own issues in the private money market, even with a Government guarantee.

The suggestion of a pooling of obligations by several borrowers under a particular HUD program and the sale of a single type of security by a trustee or marketing agent such as HUD, has been made repeatedly in respect to certain other HUD programs in addition to the college housing program. For example, a draft audit report recently prepared by HUD auditors in respect to certain aspects of the urban renewal and low-rent housing programs suggested "that an 'entity' such as the Federal National Mortgage Association (FNMA) or the Government National Mortgage Association (GNMA) be considered which would sell its Federally-secured obligations on the private market and supply funds to LPAs and LHA's for payment of their obligations as needed and authorized by HUD." In addition, other parties have suggested that the Department establish a centralized financing operation which would issue a single type of security for public sale to raise funds for the participants in certain HUD programs while the individual obligations of those participants would be held by HUD.
I should mention a couple of specific questions which occurred to me when reading The First Boston Corporation proposal. The proposal, on page 3, indicated that "each developer would be liable for only a fraction of a series of annual issues, so that his repayment obligations would be somewhat like serial maturities." It seems to me that without a sinking fund this creates a problem of cash accrual in the trust. Some thought should be given to how this problem would be handled. In addition, on page 4, the proposal indicates that "the assurance of a participation in the next combined issue would permit the developer to obtain temporary financing up to that amount from commercial banks without difficulty." I wonder how such assurance could be made sufficiently firm to provide an unquestionable basis for prior construction loans. It occurs to me that, particularly in times of economic uncertainty, it is extremely difficult to absolutely guarantee that a private market financing would take place under fixed conditions at a specific time in the somewhat distant future.

In conclusion, I suggest that a very detailed analysis should be conducted in respect to possible methods for obtaining private market financing through the public sale of obligations for the new communities program. The subject matter in question is extremely complicated and only through a carefully planned, developed and administered financing operation can the necessary funds be raised at the lowest possible interest cost. Errors in judgment in this area can result in an unnecessarily high level of interest rate charges. Such a financing operation should be developed in cooperation with major commercial and investment banking institutions and private law firms well versed in the subject.

I should mention that this office has developed and maintains contacts with representatives of such institutions and law firms and has successfully worked with them in the past in the development and revision of private market financing procedures for the urban renewal and low-rent housing programs. The problems involved are extremely complex and substantial expertise will be required to develop a financing package which is marketable on the most favorable terms.

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