

Legal

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NOTE TO: Hilbert Fefferman/Irving P. Margulies  
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High finance has arrived for MD's new community program.

Attached is a proposal for handling new community obligations which has been put together by the First Boston Corporation and I understand already presented to the Secretary; it seems to be receiving very sympathetic consideration as a method--if not the only method--for going "public" with title IV obligations.

Note that the trust notes referred to on page 3 would not be guaranteed; thus, the idea is to operate on the basis of existing law.

Any comments or reactions would be appreciated.

John A. Bell

Attachment

JABell:esm

cc: Unger

Bell

Legal /

Chron

## PROPOSAL FOR COMBINING NEW COMMUNITY OBLIGATIONS

Title IV of the Housing and Urban Development Act of 1968 authorizes a government guaranty on certain debt obligations of new community developers. The proceeds from Title IV debt can be used only for land development costs such as land acquisition, basic utilities, roads, grading, etc. The Act appears to view Title IV debt as essentially front-end money to be used in the earliest stages of a new community project and repaid as soon as possible.

There are a number of reasons for believing that the realities of new community projects will lead in many cases to a different pattern. The scope of most new community developments is so great that it is simply uneconomic to perform all of the land development initially and only then begin construction and sale. It appears to us that a cost-conscious developer will develop only as much land as he reasonably believes he can build upon and sell in the immediate future. In other words, the need for Title IV money may not exist solely at the front end, but rather be strung out over a longer period of time as the project slowly matures. This is even true for those projects who have a great deal of land purchasing to do at the front end.

We have had the opportunity to review one of the most promising new community developments, Jonathan Development Corporation in Minnesota. Jonathan projects needs for Title IV money at the initial rate of only \$600,000 each six months in the early years of the project, escalating to about twice that rate by the tenth year. Under these circumstances, what are Jonathan's financing alternatives?

1. It could take down a large amount of Title IV debt now and proceed with land developments at a pace more rapid than the one projected. This could be done up to a point, but beyond that point, interest charges on such a large amount of debt would become burdensome. In a project of this size, it is not economic to do all the land development first and all the construction later.

2. It could sell smaller issues of Title IV debt each year. This approach would allow the flow of financing to match the flow of planned development. It could be mechanically awkward, however, to go back to the market each year with a new debt instrument and seek a new guaranty.



3. It could take down a single issue of Title IV debt initially and place the proceeds in escrow, to be invested in money market instruments until needed for land development. This scheme would run a serious risk of interest rates declining in the future, so that the instruments purchased would not produce enough interest to cover the interest required on the Title IV debt.

Let us now change from the point of view of the developer to the point of view of the market for government-guaranteed debt. If each developer sells his own debt in small pieces over a series of years, it necessarily follows that the individual issues must be tailored to the developer's cash projections rather than to the preferences of the market. This may result in odd maturities or repayment schedules which could be quite difficult to sell. The market for such debt would be so fragmented that none of the purchasers would have the benefit of liquidity in a secondary market. Finally, even though the debt was guaranteed by the Government, it appears that the guaranty would be rather loose, so that due and punctual payment of principal and interest on the debt would still depend on the viability of the underlying new community project. The combination of all these factors would produce debt instruments which would have to be sold at interest rates substantially above those which can be obtained by the best Government securities. The differential would be in order of 1%, or even higher if the guaranty were particularly loose. If the guaranty were very tight, the other factors would still produce a differential of at least 1/2%.

To take an even broader point of view, we are concerned that the market for Government debt in general is rapidly being fragmented. A large number of Government agencies are planning programs which will result in the issuance of Government-guaranteed debt. The buyers of such debt are, in the end, the same buyers who would be acquiring the debt in a public market. But if the issues are allowed to splinter, conditions will be chaotic and the market extremely difficult. From the lenders' point of view, this means that those with money to provide cannot get the terms they like best and the proper liquidity. From the borrowers' point of view, it means that capital will flow first to the projects which are large and well-known and which provide proper terms and proper liquidity, while the smaller issues with non-standard terms will become increasingly marginal, expensive to sell, or, in the extremely competitive conditions which we can envision, altogether unmarketable. From the Government's point of view, fragmentation could result in a market so disorganized

that the Government's capacity for refinancing could be disrupted.

We think it is desirable from every point of view that the obligations under the new community program be combined. Such a program might work approximately as follows. Individual developers would apply to HUD for admission to the program and, when approved, be granted something like a "line of credit" (say for \$20 million over a 10 year period) in the form of a commitment to guarantee their notes when issued. Each year, all approved developers would submit a budget of their Title IV needs for the coming year, and these needs would be aggregated into a single amount. A trustee would be appointed to purchase the combined obligations in this amount and issue trust notes under which a purchaser of part of the issue would be acquiring a proportionate share in the guaranteed obligations of all the underlying developers who participate in that year.

The advantages of combined obligations are substantial. First, it would minimize the developer's difficulties in securing annual Title IV financing, for instead of having to sell his own debt he would be assured of a tap on the pool. Second, it would permit debt instruments to be tailored to the preferences of the market rather than to the cash flow of a particular developer, thereby securing the best possible interest rate. In general, the kind of Government obligation most favored by the public market is a straight instrument of either intermediate term (3 - 5 years) or long term (20 - 25 years). The instrument would have no sinking fund and, to obtain the best interest rate, would not be callable prior to maturity. If an individual developer tried to sell such a bond in any substantial size, he would be faced with a large and sudden cash drain at the time of maturity. Under the arrangement proposed, however, 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 is a recurring problem in the market for Government debt that issuers prefer serial maturities while the market prefers a single fixed maturity; the pooling arrangement provides the best of both worlds by giving fixed maturities to the market and the equivalent of serial maturities to the developers. Another advantage of combining obligations is that it permits the risk to be diversified so that the debt purchasers feel that, beyond the guaranty, their security is not linked to the fortunes of a single new community project. Risk would be spread over many projects, and the debt would appear from the investors' point of view to be somewhat like Government agency debt. Finally, and perhaps most important of all, combination would permit issues of sufficient size that a secondary market could be established. The promise of liquidity to the buyers will make



the issues substantially more attractive.

Certain further points should be noted in passing. The combining of issues would provide economies of scale in marketing debt, so that both the underwriting fees and the overall time spent would be reduced to a minimum. Combining would in no way inhibit local financing of new community projects, since land development needs constitute only a fraction of a developer's aggregate cash expenditures. Construction mortgages are a much greater cash need, and these would logically be supplied by local capital. If anything, the proposal would aid local financing by freeing capital sources near the project for construction loans. As to timing, a developer need not be held back by the scheduling of the annual issues, since 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. Also, the acceptance of combination as the most advantageous structure in the long run should not prevent the near-term approval of a guaranty for certain developers who have an immediate need for Title IV money and are prepared to proceed with a certain amount of individual financing before the long-term program is operative.

We believe that this proposal would be most advantageous for the new communities program, and submit it herewith for your consideration.

THE FIRST BOSTON CORPORATION  
September 16, 1969