HAWKINS ADVISORY

New Regulations for SLGS

Introduction. On June 30, 2005, Treasury published final regulations under 31 C.F.R. Part 344 (70 FR 37904 June 30, 2005) regarding U.S. Treasury obligations of the State and Local Government Series ("SLGS"), which went into effect on August 15, 2005. (These final rules and the prior rules are referred to as the "Final SLGS Rules" and the "Prior SLGS Rules," respectively.) Treasury created the SLGS program to assist issuers of tax-exempt bonds in complying with applicable arbitrage investment restrictions through investments of bond proceeds in tailored SLGS at restricted yields. SLGS are used primarily in refunding escrows for advance refundings of prior tax-exempt bonds.

In general, the Final SLGS Rules impose a host of new restrictions on the SLGS program. The Final SLGS Rules mandate use of an internet method for SLGS subscriptions, limit changes in SLGS subscriptions, effectively prohibit cancellations of SLGS subscriptions without penalty, and restrict SLGS redemptions in various ways. The Final SLGS Rules also introduce new requirements for yield certifications on purchasing and redeeming SLGS which will limit the ability of issuers to restructure escrows to reinvest at higher yields. The following discussion highlights selected aspects of the Final SLGS Rules.

Subscription Methods and Timing. The Final SLGS Rules mandate the use of an internet method for SLGS subscriptions called "SLGSafe," which is the internet website created for this purpose through which registered users can subscribe for and redeem SLGS. Based on Hawkins' experience, the SLGSafe internet program seems quite workable. Paper or fax methods may be used only if SLGSafe is unavailable. Subscribers may subscribe for SLGS during SLGSafe's open trading hours, which run for the 12-hour window between 10 A.M. and 10 P.M. Eastern Time. The Final SLGS Rules continue the existing timing rule that SLGS subscriptions must be made at least 7 days (5 days if principal amount of the SLGS does not exceed $10 million), but no earlier than 60 days, before the issue date.

(Continued on page 2)

Among the Best

We are pleased to note that Hawkins Partner Howard Zucker was included among the 2005-2006 "Best Lawyers in America." This survey is conducted and maintained by ALM, a leading media company. The process of selection is done by a survey of peers, including a solicitation for nominees that went out to over 18,000 lawyers. Mr. Zucker was the only bond lawyer in New York so designated.

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2005 Year-to-Date Volume: Record-Setting Trend

The municipal market achieved record volume levels for the first half of the year, according to Thomson Financial. The long-term issuance for the first six months of 2005 was $206.3 billion, well ahead of last year and slightly ahead of the amount issued during the same period in 2003, a record-setting year. The major component of growth in volume has been from refundings. Short-term rates have risen as a result of recent Federal Reserve Board tightening, while long-term rates continue to stay at historically low levels. This "flattened" yield curve makes refundings more efficient.

Once again, Hawkins Delafield & Wood LLP ranked first in the underwriters' counsel category, and was ranked highly in the bond counsel category as well. The Firm's ranking in the underwriters' counsel category, as well as those of our nearest competitors, is listed below.

NATIONAL RANKINGS - UNDERWRITERS' COUNSEL
JANUARY 1 – JUNE 30, 2005

Rank	Firm	Par Amount ($ millions)
1	**Hawkins Delafield & Wood LLP**	**6,204.0**
2	Squire Sanders & Dempsey LLP	5,840.8
3	Orrick Herrington & Sutcliffe LLP	5,312.1
4	Clifford Chance US LLP	4,537.8
5	Fulbright & Jaworski LLP	4,463.8
6	Nixon Peabody LLP	3,680.8
7	Andrews Kurth LLP	3,210.1
8	Mintz Levin Cohn Ferris Glovsky & Popeo PC	3,164.2
9	Locke Liddell & Sapp LLP	2,998.6
10	Foley & Lardner LLP	2,892.3

Source: Thomson Financial

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No Cancellations of Subscriptions. The Final SLGS Rules prohibit cancellation of SLGS subscriptions without penalty except in very narrow circumstances. To cancel a SLGS subscription without penalty, subscribers must establish to the satisfaction of the U.S. Treasury that the cancellation was required for reasons unrelated to the use of the SLGS program to create a cost-free option. Examples of such cost-free options include the simultaneous purchase of SLGS and marketable securities each of which are sufficient for a refunding defeasance or the simultaneous subscription for SLGS and the sale of an option to purchase marketable securities. Practically, however, Treasury generally views all SLGS subscriptions as such cost-free options, and thus Treasury approvals for cancellations of such subscriptions are expected to be rare. The penalty for failure to settle on a SLGS subscription is a six-month prohibition against subscribing for SLGS, which is imposed against the issuer or the conduit borrower, as applicable. This new prohibition on cancellations of SLGS subscriptions will eliminate the previous practice under the Prior SLGS Rules which had allowed issuers to cancel and resubscribe for SLGS to "float up" with the market when interest rates improved during the subscription period.

Changes in Principal Amounts. The Final SLGS Rules limit changes in the principal amount of a SLGS subscription to not more than a 10% increase or decrease of the original subscription amount. Previously, the Prior SLGS Rules permitted such changes up to the greater of $10 million or 10% of the original subscription amount. A request for such a change must be made by 3 P.M. Eastern Time on the issue date.

No Changes in Issue Dates. The Final SLGS Rules generally prohibit changes in the issue date of SLGS. Previously, the Prior SLGS Rules permitted subscribers to change the issue date of SLGS by up to seven days without restriction. In a very limited circumstance, the Final SLGS Rules permit subscribers to extend the issue date of SLGS by up to 7 days after the original issue date if the subscriber establishes to the satisfaction of the U.S. Treasury that the change was required as a result of unforeseen circumstances that were beyond the control of the subscriber at the time of the original subscription (e.g., a natural disaster). A request for such a change must be made by 3 P.M. Eastern Time on the original issue date.

New Yield Restrictions for SLGS Purchases and Redemptions. The Final SLGS rules adopt a series of major new yield restrictions which generally prohibit reinvestment transactions involving the purchase or redemption of SLGS in which reinvestments are made at greater yields. These new yield restriction rules will limit escrow restructurings at greater yields. These new yield restriction rules are complex and warrant careful review. For purposes of these new yield restrictions, the Final SLGS Rules use the arbitrage definition of "yield" under Treas. Reg. §1.148-5. Briefly, under the Final SLGS Rules, a subscriber for SLGS must make the following certifications for the noted transactions:

Open markets to SLGS. If an issuer is purchasing SLGS with any amount received from the sale or redemption (at the option of the holder) before maturity of any marketable security, the subscriber must certify that the yield on the SLGS security to be purchased does not exceed the yield at which the marketable security was sold or redeemed.

SLGS to SLGS. If an issuer is purchasing SLGS with any amount received from the redemption before maturity of Time Deposit SLGS (other than zero interest SLGS), the subscriber must certify that the yield on the SLGS security to be purchased does not exceed the yield that was used to determine the amount of redemption proceeds for such redeemed SLGS security.

SLGS to Open Markets. If an issuer is purchasing any investments from any amount received from the redemption before maturity of Time Deposit SLGS (other than zero interest SLGS), the subscriber must certify that no amount received from the redemption of the SLGS will be invested at a yield that exceeds the yield that is used to determine the amount of investment proceeds for such redeemed Time Deposit SLGS.

One example in the Final SLGS Rules illustrates that it is permissible to redeem SLGS before maturity, re-invest in short-term SLGS at a lower yield, and then reinvest the amounts received from the short-term SLGS at maturity at a higher yield. The key to this example was that the higher-yielding investment was made only from amounts received at maturity rather than from restricted amounts derived from an early redemption. Another example illustrates that it may be problematic to make the required yield certifications if the reinvestments are made on the same day as a SLGS redemption because of the potential for market fluctuations during the 12-hour window in which SLGS rates remain constant.

Other SLGS Redemption Rules. The Final SLGS Rules require that subscribers submit a redemption notice to Treasury at least 14 days (previously 10 days), but not more than 60 days, before the requested redemption date to redeem SLGS. The Final SLGS Rules prohibit redemption notices for unissued SLGS and prohibit the cancellation of SLGS redemption notices.

SLGS Rate Differential. To make SLGS more competitive, the Final SLGS Rules lower the rate differential on new SLGS to one basis point (.01%) below comparable open market U.S. Treasuries (versus 5 basis points (.05%) below such open market U.S. Treasuries under the Prior SLGS Rules). New SLGS rates will be established daily by 10 A.M. Eastern Time and will remain in effect for SLGS purchases until 10:00 P.M. Eastern Time on that same day.

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2005 Public Housing Finance Update

Financing is a relatively new option for public housing authorities (PHAs). Nevertheless, for many PHAs, it is essential to their progress. A consultant study published by HUD in 2000 found a $21.6 billion unfunded backlog of capital needs as of 1998, and about $2 billion annually resulting from depreciation. In the face of these needs, appropriations barely have covered more than the amount necessary for PHAs to stay even. The budget for fiscal 2006 proposed by both the Administration and the Senate Appropriations Committee would reduce capital funding significantly.

The Quality Housing and Work Responsibility Act of 1998 (QHWRA) authorized several potential public housing financing mechanisms. The borrowing mechanism mostly used thus far has been named the Capital Fund Financing Program (CFFP) by HUD. Under CFFP, PHAs pledge the future receipt of the federal Capital Funds that they receive annually, for up to 20 years, to repay bonds or loans. Because the only resource for repayment is the Capital Fund, and annual Capital Fund amounts are subject to appropriations, bond rating agencies and individual lenders generally have insisted on debt service coverage ratios of at least three to one. This means that if a PHA's most recent Capital Fund grant is $3 million, the PHA could not pledge more than $1 million annually to repay the bonds or loans. Depending on market interest rates and other variables, such a pledged amount might raise about $13 million--more than the PHA otherwise would receive over four years.

CFFP: Events of the Past Year

By the end of May 2004, HUD had approved over $1.5 billion in borrowing under CFFP. This included various types of borrowings, all discussed below. In the last six months of 2004 and the first six months of 2005, HUD approved another $842 million in bonds or loans. $600 million of this amount was approved for the New York City Housing Authority (NYCHA). Approximately $78 million each was borrowed by the District of Columbia Housing Authority (DCHA) and a pool of 21 New Jersey housing authorities. The remaining $87 million was spread among nine other approved transactions.

In both the NYCHA and DCHA transactions, the bond issuer was not the PHA, but instead an entity with more experience in the capital markets (New York City Housing Development Corporation for NYCHA and the District of Columbia Housing Finance Agency for DCHA). While several PHAs have used other entities to be their bond issuers for various reasons, the most replicable example is the issuance of bonds by a state housing finance agency (HFA) that will loan the bond proceeds to a group (or pool) of PHAs. The other large 2005 transaction, the New Jersey pool, is such an example and was patterned after an earlier Maryland pool. This innovation also was followed in 2005 by an Illinois pool, and is expected to be followed soon by Massachusetts and Pennsylvania pools. It is a means of allowing small PHAs to participate in the bond market and share the expenses.

Another promising development for small PHAs was exemplified by several relatively small direct loans, including loans from Fannie Mae and several banks. Such financings, instead of relying on a bond issue, are simply direct loans from lenders to PHAs.

An innovation that appears promising, but was used in only one loan approved in the past year (for Portland, Oregon), is the use of 4% tax credits to augment CFFP. This can be accomplished through a loan of Capital Fund proceeds to a limited partnership that invests both the loan proceeds and tax credit equity in the public housing. The PHA must obtain tax-exempt bond volume cap and thus the ability to raise "private activity bonds" which can generate the 4% tax credits. Even though this mechanism results in some degree of loss of ownership and control to PHAs, and its administrative costs make it uneconomical for the smallest transactions, it has considerable potential. While CFFP accelerates the availability of funds that a PHA is scheduled to receive, the use of tax credits permanently increases the total funds available.

The volume of CFFP loans will continue to be related to the speed and efficiency of HUD processing of requests for approval. HUD added staff to improve this effort, and late in the year, added a contractor. HUD also published basic information regarding CFFP requirements on its website. This is an important step, because there are no regulations or notices explaining CFFP requirements. Even with this step, HUD policies regarding CFFP continue to evolve and in some respects new requirements are being added. The availability of the website material is helpful, but thus far has not provided all of the necessary information as HUD requirements continue to change.

Despite the lack of regulations or notices, CFFP is becoming more established. The development of mechanisms that can be efficiently used by smaller PHAs, notably bond pools and direct loans, is an important step forward. The use of CFFP in conjunction with tax credits has promising potential.

The Alternative of Property-based Financing

In addition to the CFFP approach, QHWRA authorized PHAs to mortgage their public housing, either for the renovation of that site or the production or renovation of other public or affordable housing (Section 30 of the United States Housing Act of 1937, sometimes referenced simply as Section 30). For the fiscal 2003 and 2004 budgets, the President proposed an approach under which PHAs could trade in their public housing subsidies on a development-by-development basis for project-based vouchers and then borrow against the individual properties. Under both approaches, the public housing property rather than simply the promise of future appropriations would be used for collateral. This means that more funds could be borrowed than under CFFP relative to the amount of funds pledged for repayment, because lenders would demand a far smaller debt service coverage ratio in view of their added loan security. The trade-off is that public housing properties would be put at risk of foreclosure.

To rehabilitate or develop public housing using Section 30 would require the pledging of public housing rents, operating subsidy and capital funds as well as mortgaging. While QHWRA allowed for the pledging of oper-

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ating funds as well as Capital Funds, HUD has not issued the necessary regulation or guidance. HUD also has not issued a regulation regarding mortgaging. Instead, HUD has provided case-by-case approval of only a few transactions that use Section 30 to a limited extent.

Neither HUD nor Congress is pursuing the legislation that would allow substituting project-based vouchers for public housing subsidies, and undertaking property-based financing supported by the vouchers, to go forward. Some PHAs, notably the San Francisco Housing Authority, have found ways to use project-based vouchers in this manner in a few instances under current law.

Mixed Finance

QHWRA also codified several requirements for PHAs undertaking "mixed finance" investments, using private as well as public sources of financing. These provisions are an outgrowth of a 1994 opinion of HUD's General Counsel, which clarified that public housing need not be owned by a PHA as long as the owner follows all public housing laws and regulations. The HUD legal opinion and QHWRA made it possible for limited partnerships and limited liability corporations that could use low-income housing tax credits to own and invest in developments containing public housing. While the initial investments of this kind mostly were in connection with large HOPE VI grants, tax credit investments increasingly have been combined with Capital Funds.

General Suggestions Regarding Future Efforts

The likely lack of adequate public housing capital appropriations in the coming years dictates that public housing leveraging will continue to expand. If CFFP is to be the main vehicle, HUD must settle upon its regulatory process and carefully balance its legitimate regulatory concerns with the need to move these financings forward. HUD also should continue to develop the property-based financing framework, so that this can become a realistic leveraging possibility where it would make sense for an individual PHA's situation. Finally, the volume of non-HOPE VI mixed finance transactions is likely to continue to grow. HUD will need to increase its processing capacity and look for further streamlining of the approval processes, to provide maximum support for leveraging of private sector funds to improve public housing.

(Note: A version of this article appears in the Sept./Oct. 2005 issue of the *Journal of Housing and Community Development*.)

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San Francisco's First Variable Rate General Obligation Bond Offering

The City and County of San Francisco recently issued $120 million in variable rate general obligation bonds to finance the reconstruction of Laguna Honda Hospital, a city-owned long-term care facility. The bonds were sold in three series as weekly variable rate demand obligations, together with a $110 million issue of fixed rate bonds. As Bond Counsel in this noteworthy transaction, Hawkins Delafield & Wood LLP assisted the City with an innovative approach to a traditional form of municipal borrowing. Hawkins believes this financing is the first time that variable rate general obligation bonds have been issued by a local public agency in California.

In order to craft an approach that would successfully address a number of legal and financial challenges, Hawkins attorneys carefully studied the City's Charter, the California Constitution and other relevant legal sources in regard to variable rate financings. Working closely with the San Francisco City Attorney's Office, Hawkins was able to draft an ordinance and multi-modal bond indenture that implemented the City's desired financing strategy and satisfied the rating agencies and credit enhancers. The bonds were enhanced by a JP Morgan Chase Bank liquidity facility and MBIA bond insurance and received "AAA" and the highest short term ratings from all three rating agencies.

The issuance of $299 million in bonds to reconstruct Laguna Honda Hospital was approved by 73% of the City's voters in an election held in November 1999. Laguna Honda Hospital originally opened in 1866 and currently provides over 1,000 residents with long-term care regardless of their ability to pay. The hospital also provides adult day health care and senior nutrition programs.

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