

Office of the President
March 6, 2002

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ITEM FOR ACTION

For Meeting of March 13, 2002

**ESTABLISHMENT OF LOAN PORTFOLIO SALE PROGRAM FOR THE
UNIVERSITY OF CALIFORNIA MORTGAGE ORIGINATION PROGRAM**

The President recommends that the Committee on Finance recommend to The Regents that The Regents authorize the establishment of a program for the periodic sale of all or portions of the Mortgage Origination Program (MOP) loan portfolio to increase the level of MOP liquidity for the purposes of providing additional loans for the recruitment and retention of faculty and other employees in support of projected student enrollment growth, subject to the following:

- (1) The MOP Portfolio Sale Program shall be conducted to provide additional funding for future MOP loans, within the following parameters authorized by The Regents:
 - a. Proceeds from the MOP Sale Portfolio Program shall be deposited in STIP and be available for additional funding for new mortgage loan originations within the limits already established by The Regents for MOP. MOP loans sold shall be deducted from the total MOP funding provided by STIP;
 - b. If the sale of any portion of MOP results in proceeds less than the outstanding receivables of the MOP loans sold (Par Value), a funding source must be approved by the President (if the funding source is within Presidential control) or by The Regents (if the proposed fund source is not within Presidential control);
 - c. No sale of MOP Portfolio loans shall extend the term of any individual MOP loan or modify the interest rate to be charged under MOP parameters; and
 - d. Purchasers of MOP loans shall have no recourse to Regental funds and shall be repaid only from individual mortgage loan repayments and/or property securing each individual loan, except that any such sale of MOP Portfolio loans may include terms that: (a) provide for The Regents to make monthly remittances of principal and interest to the purchaser for all loans sold, which are not in arrears in excess of three months, by an agreed time each month, and (b) provide for the exchanging of any loan sold to the purchaser that becomes non-performing, for more than an agreed to time period, with another MOP loan of similar size and characteristics at the same discount rate, if any, that applied to the original loan sale.

- (2) Each sale pursuant to the MOP Portfolio Sale Program shall be reported to The Regents, together with information related to the loans sold, fund source used if the sale results in less than the Par Value of loans sold, and an update of unused funding for MOP Program authorized by The Regents.
- (3) The President, after consultation with the General Counsel, shall be authorized to execute such documents as may be necessary to effect any sale pursuant to the MOP Portfolio Sale Program.

BACKGROUND

At the November 2001 meeting, The Regents approved four initial recommendations of the UC Housing Task Force designed to strengthen the ability of existing faculty and staff financial assistance programs to address the growing housing affordability gap near most University campuses. Those recommendations made changes to existing mortgage products and created a new graduated payment option under the Mortgage Origination Program to increase the purchasing power of University loan products in the face of rapidly rising housing costs near most UC locations over the past two to three years.

The UC Housing Task Force, through its New Financial Programs Subcommittee, continues to explore additional ways to leverage existing University resources to increase availability of current and/or new financial assistance programs. Increasing the resources available for financial assistance is key to meeting the demand for housing assistance caused by increased faculty recruitment. Further resources will be required if there is any significant broadening of program eligibility beyond the current Academic Senate and Senior Management Group categories. One approach to increase resource availability is periodic sale of MOP loans to support increased levels of lending activity. The New Financial Programs Subcommittee completed initial investigation of this option and reported its findings and recommendations to the UC Housing Task Force at its November 2001 meeting.

Recommendation

Based upon the report of the New Financial Programs Subcommittee, the UC Housing Task Force recommended that the University pursue a direct sale of a portion of the existing MOP portfolio under the general structure and parameters discussed under Option 1, as further detailed below. As further discussed below, such a sale would more likely than not be at some discount, requiring the identification of a fund source to cover the differential between the discount price and outstanding Par Value sold to the investor. As of June 30, 2001, the balance of the Faculty Housing Reserve Fund was \$18.6 million. If a sale of \$100 million of MOP loans could be accomplished at 98% of par, the cost to the University would be \$2 million, plus transaction costs that are estimated at \$300,000. Given the balance and obligations of the Faculty Housing Reserve Fund, it could be used as a fund source for such a sale on a one-time basis to test the ability to successfully complete such a sale at an acceptable price. Future sales, if any, would require identification of other fund sources.

An overview of the MOP portfolio and a summary of the Subcommittee's investigation are presented below.

General analysis of the Mortgage Origination Program portfolio

MOP lending criteria allow eligible faculty and staff to borrow up to 90% of the house value with a loan maturity of up to 40 years. The interest rate is indexed to the most recently available 4-quarter average return of STIP plus a 0.25% service fee. Interest rates are adjusted annually for each loan on the anniversary of the origination date, with a maximum annual adjustment of 1%. MOP loan underwriting permits mortgage payments to be as high as 40% of gross family income. Unlike the commercial market, private mortgage insurance (PMI) is not required for loans above an 80% loan to value ratio. With the changes approved by The Regents in November 2001, a graduated payment loan option has been added to the program (GP-MOP) that allows campuses to reduce the initial rate paid by the borrower and to provide funds to STIP to cover up to a 3.0% reduction in the standard program interest rate. The differential paid by the campus would be reduced by 0.25% to 0.50% annually, until the borrower is paying the program rate in a 6 to 12 year period depending upon the initial reduction amount and the annual adjustment factor. It is not currently being proposed that any GP-MOP loans be sold as part of the first MOP Portfolio loan sale.

As of December 31, 2001, 2,396 MOP loans totaling \$653.6 million had been funded and there remained 1,510 active loans with an aggregate outstanding balance totaling \$424.5 million, and an average outstanding loan amount of \$281,117. The MOP loan prepayment rate for the past five fiscal years has averaged 6.63%, which is slightly higher than the national average of 6%. Of the 886 loans that have been paid off under the program, the average maturity has been 6.65 years. As of June 30, 2001, the balance of the Faculty Housing Reserve Fund was \$18.6 million. The principal balance and income of the Reserve are dedicated to administrative and program costs relating to faculty lending programs, including covering any principal losses or earnings shortfalls of the MOP portfolio to STIP. The only principal losses for the MOP portfolio occurred in fiscal years 1994-95 through 1996-97, following the severe downturn in the California Residential Real Estate market of the early 1990s. The losses, totaling \$1,041,153, representing 0.16% of the total loans made, were all covered by the Reserve through transfers into STIP.

STIP

STIP has an average maturity ranging from 18 months to 28 months. At December 31, 2001 it had an average maturity of 24 months and a yield of 5.23%. Over the past 10 years, STIP has outperformed indices typically used for commercial real estate loans, but not to the same extent of the spread above the indices that most commercial lenders use for adjustable rate mortgages (ARMs). For example, current mortgage loans are available for ARMs based on 11th District COF + 2.5% or 1-year Treasury + 2.75%. STIP, by comparison, exceeds these indices, but at less than the spread above the index used for traditional ARMs:

STIP Yield	Spread above	
	11 th District COF	1 Yr Treasury
5 year average 6.05%	+1.24	+0.98
10 year average 6.24%	+1.44	+1.28

Overall, MOP is viewed as being a strong program with low delinquencies. However, since certain MOP loan characteristics are unusual compared to those typical in the market, MOP is seen as having negative value when compared to mortgage programs with traditional underwriting standards such as pricing index (STIP vs. traditional indices), maximum interest rate increase each reset period, maximum LTV, and maximum percentage of monthly income committed to mortgage payments. These factors may make it difficult to market MOP loans at the same discounts from Par Value as are typical for other traditional loans.

Three Options Investigated by the Subcommittee for Increasing Liquidity for MOP Lending

Option 1: Sale of \$100 million to an institutional investor through a private placement

Several institutional investors were approached on a “no-name” basis to elicit their interest in purchasing a portion of or the entire MOP portfolio. Based on the investors’ analyses of STIP and MOP versus traditional indices and underwriting criteria for ARMs, discounts for a purchase of MOP loans ranged from 92% to 98% of Par Value.

Those discussions indicated that the following parameters may either increase interest in a purchase of a portion of MOP loans and/or serve to increase the price bid for the purchase:

- Establish an initial sale of at least \$100 million;
- Sell only loans that are below 80% LTV and have FICO credit score above 600 (the average FICO score for MOP borrowers who received loans since August 1998 is 752);
- Reduce service fee from 25 basis points (bp) to 12.5bp (the trade-off of decreased on-going program revenues would detract from the attractiveness of this option);
- Guarantee remittance of monthly payments by the 5th business day of the month for all MOP loans sold;
- Guarantee to take back any loan that becomes more than 30 or 60 days in arrears and substitute another loan of equivalent size and characteristics;
- Sell loans furthest from the date when the interest rate adjusts for the next 12 months;
- Exclude MOP loans with a term of more than 30 years from the sale portfolio;
- Exclude the new GP-MOP product from initial sales.

As required by the actions, sale of loans will not change individual loan parameters in any way nor pledge any assets of the University for loan repayment. However, as provided in the actions, any such sale of loans may provide for the making of monthly remittances to the purchaser for loans not in arrears for more than three months and the loan substitution outlined in the above parameters in order to increase the price offered for the loans. These guarantees are similar to those provided under the current program structure to STIP and would continue to be assessed to the Faculty Housing Reserve Fund. Sale proceeds will be deposited in STIP to be available for additional mortgage originations within the limits established by The Regents for MOP. STIP

will suffer no loss of principal or income as a result of any loan sales.

Option 2. Issuance of bonds secured by mortgages

Under this approach, the University would create an additional pool of funds for mortgage loans through the sale of debt, either in the form of: (1) a taxable revenue bond backed by the mortgages or (2) a more complicated vehicle that uses a Collateralized Mortgage Obligation (CMO) or REMIC structure. Repayment of debt service would come from payments due from the mortgages comprising the portfolio, which would serve as collateral for the bonds. Most CMOs or REMICs are sold by Fannie Mae and Freddie Mac. "Private label" REMICs are sold by other financial institutions and priced at a spread above Fannie Mae or Freddie Mac securities of similar maturity, weighted average life (based on prepayment history), and weighted average coupon. The additional spread for the "private label" issues is needed to compensate investors for higher risks compared to Fannie Mae or Freddie Mac debt.

While most CMOs and REMICs are done for fixed rate mortgages, they are also used for variable rate mortgages. A CMO or REMIC structure is generally far more costly and elaborate to comply with SEC rules than the direct sale approach discussed above.

Regardless of the structure, the same MOP program characteristics that could result in the private placement of the MOP portfolio at a purchase price below par also create significant pricing difficulties for this borrowing structure. The two major types of risks to investors under this structure relate to credit quality of the portfolio and interest rates.

In order to meet the credit quality threshold to sell such debt publicly, an AA rating would be needed for optimum execution. To achieve this rating, the University's rating could be used by guaranteeing timely payment on the mortgages, or a portfolio of \$100 million could be used as collateral, with a portion being sold to the public (e.g, \$80 or \$90 million) and the University retaining the payments on the remaining amount.

Covering the interest rate risk is more problematic because the loan rates are not based on a common index. It is likely that investors may insist on variable rate debt payments based on a standard index. To achieve that outcome, the University would need to take significant interest rate risk. For example, the University could simply issue taxable revenue bonds with a variable rate based on the 2-year Treasury (the proxy for STIP) and reset each month or quarter. The University would then take the risk between such a variable rate and the actual net rate on the loans after servicing. The University could seek to hedge against this risk, but such a hedge would be highly complex because the prepayment speed on the mortgages is uncertain. A fund source would need to be identified to pay the difference between the STIP rate and the borrowing cost. It is unlikely that the University could fully offset this risk without significant cost or remaining exposure.

While such debt approaches are possible, they are likely to be highly complex in terms of disclosure, the risks involved, and the ongoing obligations of the University. The issuance of debt would also involve greater transaction costs and longer lead-time than the MOP Portfolio Sale Program discussed earlier.

Option 3: Sale of \$100 million to UCRS

The Subcommittee reviewed, but did not recommend, an alternative program approach involving UCRS direct purchase of a portion of the MOP portfolio (as described in Option 1 above). UCRS currently invests in CMOs, which are priced at competitive yields for GNMA and REMICs. It may be possible to structure a portfolio sale to UCRS, which could be viewed as an arms-length transaction such that it would provide the same liquidity to MOP as Option 1 above, but with more flexibility for managing the balance of the MOP portfolio in STIP. For example, it may not be necessary to reduce the servicing fee or guarantee payment by the 5th of the month to successfully complete a sale to UCRS. A sale to UCRS would have lower transaction costs, and the pricing of the portfolio, although required to be an equivalent market price, may be priced closer to or at par than the private placement in Option 1, as the parameters of MOP are broadly understood and accepted by the UCRS board. Unfortunately, advice from counsel on this matter indicates that such an approach would not fit within the exceptions envisioned under section 72(p) of the Internal Revenue Code, which normally treats loans made to plan participants (except those meeting certain limited exceptions) as distributions from the plan subject to taxation and certain penalties.

Management of the MOP Portfolio Sale Program

The MOP Portfolio Sales Program would be managed by the Office of the President (Faculty Housing Loan Program and External Finance). To the extent necessary, the Program will be assisted by financial consulting services, whose fees shall be included as part of the costs of the particular sale.

The documentation necessary for such a sale of loans would include: (1) a prospectus describing the University, its faculty, and the MOP program and portfolio, (2) a Purchase and Service Agreement (PaSA), and (3) representations and warranties based on authorization by The Regents. All documentation shall be drafted by the Office of General Counsel (OGC) or, if prepared by an institutional investor or financial consultant, shall be reviewed and approved by OGC.

As required by the authorizations contained in the action, the President shall provide a report of each sale under the MOP Portfolio Sale Program.