

October 17

Responses to US News Questions

October 17, 1996

1. Your question asks about a calculation that is sometimes referred to as the "credit reform" number. That's because the calculation is required by -- and must be carried out pursuant to -- the federal Credit Reform Act of 1990 and the Office of Management and Budget's (OMB) Circular No. A-11. OMB must sign off on all credit reform calculations, and no sale proceeds without OMB's approval.

For each mortgage sale, HUD and OMB must independently determine the value of these mortgages if they were to remain in the government's inventory. Any sales proceeds generated above this value are scored as budgetary savings -- also known as "negative credit subsidy." Congress can use the money to fund other initiatives or apply the money to deficit reduction. Credit reform works the other way, too. If a sale generates less than the value of the mortgages if HUD had kept them, the Department would pay the difference.

The HUD mortgage loan sales completed in the last three years, while Hamilton has served as HUD's financial advisor, have generated approximately \$1.3 billion in negative credit subsidy. This is real money and a HUD success story!

In determining the credit reform number, the OMB circular requires that the analysis be based on the net present value of anticipated cash flows from the mortgages based on historical collections (not counting administrative expenses). In HUD's case, the collection history has been poor. Many defaulted borrowers have not made payments to the government in years. So, for example, a portfolio of loans where borrowers owe \$800 million in unpaid principal balance has not, in HUD's hands, been worth anything near that amount because hundreds of millions of dollars have not been collected by the government.

Why are the mortgages typically worth so much more in private hands (and why would some delinquent borrowers complain)? The answer is something economists call the "productivity gap."

Non-performing loans, whether for housing or any other asset, are difficult for the federal government to manage. This is because the federal government operates under certain constraints that the private sector does not. The Inspector General cites these problems as a "material weakness" in its management evaluation of HUD.

The private sector can move quickly and decisively. The private sector can negotiate. HUD is handicapped in its ability to negotiate a business deal -- such negotiations can bring charges of unfairness, favoritism and abuse, and political influence. HUD's only real alternatives are to foreclose after a fight that often causes the real estate to suffer, or grant a workout that leaves enough cash in the property to keep it livable. The private sector can negotiate a business deal that makes the property work and avoids the damaging foreclosure route. Recent events have made the gap between the government and private sector wider. With the history of Resolution Trust Corporation

(RTC) sales, there is a vibrant distressed asset management capacity in the private sector. There is increased liquidity necessary to support refinancing and restructuring. Moreover, asset managers and servicers have secured a distinct advantage in their acquisition and use of sophisticated digital and related technologies.

2. Hamilton has not steered the note sale business to any bidder, including the so-called "Wall Street" bidders. On the contrary, Hamilton specifically recommended a sale of many small lots with a mathematical optimization so that **BOTH** small and large bidders could participate in the same sale. This had not been done in any government sale before. The entire sales design and execution process, over a two year period, involved the active participation of many experts, including the HUD Inspector General's office. In fact, from the outset the IG's office was integrally involved in all aspects of the sales. Hamilton consistently received positive feedback from the IG and HUD program officials.

Like the IG at HUD and FHA's outside auditor, OMB recognized that the large inventory of defaulted loans "was compromising FHA's capacity to perform its other functions (including management and oversight of the insured mortgages in force), thereby making FHA more vulnerable to future losses."

The President's budget observed:

"In response to this large administrative burden, Congress and the Administration approved a program to sell these HUD-held mortgages in a series of competitive auctions and negotiated sales with state and local housing finance agencies. These sales have been highly successful, helping HUD reduce its inventory of mortgages, while capitalizing on the private sector's knowledge and ability to manage defaulted loans. In an improvement on earlier loan asset sales, the return to the Government was increased through the use of competitive bidding and computer technology which evaluates and optimizes competing bids." (p. 290). (Source: Budget of the United States Government FY97, Analytical Perspectives, Chapter 21. Loan Asset Valuation)

The competitive auction process that HUD uses makes it impossible to steer the auction to any bidder. Indeed, an understanding of optimization methodology makes it clear that such activity could not occur.

The optimization technology used in some of HUD's sales was pioneered by Lucent Technologies Bell Laboratories. Optimization makes it possible for different types of bidders to compete against one another in the same sale. This includes large firms, regional buyers, small investors, defaulted borrowers and specialized asset purchasers. Before optimization, this wasn't possible. Asset sales had to be structured either to attract large bids (as in "all or nothing" sales), regional buyers (as in geographically stratified sales) or smaller bidding groups (as in sales of individual assets). With optimization, all of these groups can compete in the same sale, and there can be multiple winners. And importantly, HUD is not in the position of trying to predict investors' preferences for packaging loans.

This heightened competition generates higher proceeds from the note sales than would otherwise have been generated by sales of the very same assets.

Where large financial institutions (which you refer to as "Wall Street," apparently to thrill your readers) have won, it is because they have bid more than smaller, less-well-capitalized bidders. Their low cost of capital, economies of scale, nationwide network of real estate managers, more efficient servicing, different exit strategies and access to financing may give them an advantage, but the optimization model does not. HUD and Hamilton marketed aggressively to all types of bidders, searching for the highest price. This is what a financial advisor is paid to do.

As you know, the HUD mortgage loan sales program has used a variety of sales structures. Each transaction, even with optimization, has differed as HUD sought to enhance results and learn from sales. In each case in which we have recommended a sales strategy, we have sought to maximize benefits to the taxpayers and improve neighborhoods, rather than cater to special interest bidders.

We considered the alternative to an optimization process--sequential or simultaneous lot-by-lot auctions--and determined that this would have meant lower prices. We know that the RTC was under considerable pressure to favor one interest group over another. When the RTC tailored sales to one or another group, some constituencies were happy and others were not. HUD had no wish to create a program of easy money for low bidders; it wished to sell for top dollar to return as much dollars as possible to the number 1 constituency--the American taxpayer.

3. Hamilton has no financial ties to BlackRock. The only relationship between the companies was BlackRock's role in the Partially Assisted sale and no other relationships are contemplated.

BlackRock was hired by Hamilton to work specifically on the June 1996 sale of 158 partially assisted multifamily mortgages and added huge value to the transaction.

BlackRock's service in the multifamily sale did not give the firm any advantage in the single family bidding. Single family sales are all competitive sealed bid auctions. The Bell Labs computer model which selects winning bid combinations uses bidder identification numbers only, not the names of bidders. Moreover, each bidder is given the same information.

BlackRock's role on the multifamily sale was fully disclosed to HUD prior to the sales. BlackRock, like many investment firms, from time to time finds itself involved in different transactions. Bidding on a one sale and working on a completely different sale does not violate HUD's conflict of interest rules, federal regulations or contracting requirements and is consistent with the practices of the RTC.

4. We are troubled that this material, which is proprietary, is in your hands. Nevertheless, you have your facts wrong and we said no such thing. The sentence in Hamilton's July 1993 BAFO discussed Wall Street firms' desire to gain competitive advantage against each other. To take advantage of this desire--and thereby increase competition and raise prices--HUD and Hamilton provided to the entire marketplace an

overload of due diligence, loan sale procedural documents, internet bulletin board items and other public information.

5. The reference cited from Hamilton's July 1993 BAFO, and taken out of context, specifically refers only to one particular \$90 million pool of Section 221(g)(4) performing, seasoned insured mortgages and not HUD's \$11 total loan sale portfolio. As you may know, with performing loans there are no workouts or restructurings to accomplish, only a few basis points of servicing and spread. Thus, this particular portfolio's price would obviously be maximized by specifying that bidders put in "all or nothing" bids, since bidders only care about economies of scale and are not viewing the purchase as a real estate play in a portfolio of this size. This advice was sound and the same advice that we would give today on a small, multifamily insured mortgage sale.

6. Hamilton has no knowledge of the favorable treatment you allege.

7. Hamilton understands and abides by Federal Acquisition Regulations and employs professionals experienced in federal contracting to ensure compliance to the best of our ability. Ms. Dunlap paid her own way for expenses. The same answer applies to your additional question about trips by Kathryn Rock. Neither Hamilton nor its employees paid Ms. Rock's expenses related to a trip this summer. More broadly, we know of no instance in which Hamilton or its employees paid Ms. Rock's expenses.

8. Hamilton did not have the authority to have Ms. May or any other HUD employee moved to another position at the Department.

9. The Clinton Administration revived the idea of mortgage sales at HUD. Neither Hamilton nor its employees brought the idea to the current HUD administration. Rather, Hamilton learned of HUD's renewed interest in note sales in 1993, when we received a competitive solicitation seeking a financial advisor who would assist HUD on note sales. As a HUD contractor, all of our work is specified in a scope of services. We report to a contracting officer, a government technical representative, and a government technical monitor in carrying out the scope and direction approved by program officials. As FHA Commissioner, Ms. Fitts did not recommend a note sale program to Secretary Kemp.

Actual contractor ratings are generated by the Department, and as recently as last month, the government technical representative on one recently completed sale rated Hamilton's performance as excellent.

10. Secretary Kemp requested the resignation. The reason he cited was differences in management style.

11. Hamilton was engaged by HUD to provide policy advice on the Administration's mark-to-market proposal from early 1995 to mid-1996. In providing policy advice to HUD on its mark-to-market initiative, Hamilton helped HUD develop different alternatives for dealing with the problem. We contributed ideas to the mark-to-market operating plan and officials' testimony – but HUD staff controlled the content of these and other materials at all times. In all respects, Hamilton served as HUD's advisor, striving to assist HUD in achieving its objectives.

12. The Hamilton financial advisor contract was not terminated in 1995 by the Resolution Trust Corporation. The contract expired. Under the contract, Hamilton completed one auction.

13. HUD can best address the question of who at HUD "created" Neighborhood Networks. It is an initiative of the Office of Multifamily Housing and initially the Seattle HUD Field Office was a significant driver.

e.villages is a data management company formed by Hamilton and Adelson Entertainment. *e.villages* does not receive any government funding, from HUD or any other agency. All questions regarding *e.villages* plans for developing more jobs at other sites should be directed to the *e.villages* management team.

Hamilton invested in *e.villages* because of our belief that new digital technologies had reach the point where it was now possible to bring job training, linked to real jobs, in large volume, back into the inner cities and other distressed areas. Hamilton believes that residents of the inner city must be linked to the technology arteries of the nation, and thereby to schools, jobs, health care and other opportunities, in order to create community capital.

14. Neither Hamilton nor its shareholders has had a business relationship with Michael Milken. There has been no investment in Hamilton of any kind by Mr. Milken or his entities, nor is any contemplated.

We understand that ICS considered the *e.villages* concept but subsequently determined that participation in *e.villages* would be a diversion away from its core business. As a result, Adelson and ICS agreed not to pursue a relationship together in *e.villages*.

15. Hamilton interviewed Kathy Rock for a position prior to her interviewing and then joining FHA. We were favorably impressed. When Hamilton learned that Ms. Rock was to be interviewed for the FHA Comptroller position, we discontinued all talks of employment with her. Hamilton did not make recommendations or have any discussions with HUD hiring officials about Ms. Rock.

16. Hamilton, of course, is not privy to the focus of whatever inquiry the IG is conducting. We are cooperating fully with all requests. Sadly, it appears that sources in the Inspector General's office have made selective leaks of allegations and documents to you.

For two years, the Inspector General's office had been intimately involved in the planning and review of all loan sale activities in which Hamilton was involved. This included frequent briefings, progress reports and correspondence. Part of the technology transfer we discussed with you yesterday, the Design Books, have been reviewed, commented upon and approved by the office of the IG. Comments by the IG staff regarding the program and Hamilton's performance were uniformly positive. As recent as July 30, 1996, the Inspector General, in her testimony before the House Subcommittee on Human Resources and Intergovernmental Relations, referred positively to the loan sales. Both before and since that testimony, we have been

informed that a soon -to-be released audit of the program by the IG is very favorable. We have attached excerpts from various publicly-available IG statements and we urge you to check these sources.

17. Neither Hamilton nor any shareholder has any financial ties to any of the Wall Street firms that have won note-sale business. Hamilton has no financial ties to any outside firm -- period. All of the capital needed to start and build Hamilton since its inception in 1991 has been provided by the firm's employees.

Since its inception, Hamilton has done business with three firms that have been involved in the note sales in one capacity or another. As described in our answer to question 3, Hamilton hired BlackRock to work on the partially assisted sale. BlackRock performed the work and was paid a fee. In 1993, Hamilton completed a small consulting assignment for GE Capital, for which we were paid a fee to conduct a survey of trends in the multifamily mortgage markets. From 1992-1995, Hamilton advised NHP on a variety of financial matters, for which Hamilton was paid a fee.

18. We have no knowledge of the "brown bag" lunch to which you referred.

Attachment

October 21, 1996

we would like to propose to HUD
with \$10,000,000 / 5,000 / 2,000

We would like to congratulate the U.S. Department of Housing and Urban Development for their successful sale of over \$5 billion dollars (unpaid principal balance) of performing and defaulted mortgages, resulting in:

\$1,300,000,000

\$ 1.3 Billion of Taxpayer Savings

The U.S. Department of Housing and Urban Development Federal Housing Administration (FHA)

FHA-Held Multifamily and Single Family Mortgage Sales

Sale	Date	Sale Principal
Single Family 221(g)(4) Loans	June 1994	\$ 97,493,000
Title X Land Development Loans	June 1994	98,717,000
FNMA Multifamily Reassignment	August 1994	100,000,000
Multifamily 221(g)(4) Loans	October 1994	149,029,000
Multifamily Unsubsidized Southeast Loans	March 1995	906,978,000
Multifamily Performing National Loans	August 1995	290,962,000
Multifamily Unsubsidized Western US Loans	August 1995	622,337,000
Single Family National Sale #1	November 1995	521,300,000
Title I Manufactured Housing Loans	November 1995	100,000,000
Single Family National Sale #2	March 1996	741,483,000
Partially Assisted Multifamily Loans	June 1996	800,000,000
State of Missouri Subsidized Loans	September 1996	29,000,000
Multifamily Unsubsidized North/Central Loans	August 1996	700,000,000
Single Family National Sale #3	September 1996	700,000,000
		5,769,549,000

The undersigned have acted as Financial Advisors to the Department in these sales. A portion of the \$1.3 billion in savings has been dedicated to the financing of affordable housing for low and moderate income residents. This announcement appears as a matter of record only.

The Hamilton Securities Group, Inc.

Cushman & Wakefield, Inc.

~~Ernst & Young, LLP~~

Merrill Lynch, Inc.

Handwritten signature/initials

Law Firms
Asset Mgt.