

Report on the Anna Racheva Thesis:

“Essays on the Default of California Non-Rated Land Secured Bonds”

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This thesis covers three topics related to California non-rated land secured bonds: the first dealing with default rates, the second analyzing the complexities of curing partial defaults, and the third identifying factors that may determine defaults. These topics, although offering different perspectives, are actually interrelated in that they provide insight on the importance of initially structuring non-rated land secured bond issues properly, so that the potential for future defaults may be reduced, considering the difficulties of curing such defaults.

With regards to my background for reviewing the thesis, I will be using the combination of my academic training as an economist combined with more than twenty years of experience in performing market studies for more than four-hundred land secured bond issues amounting to some \$7.5 billion.

Chapter II: Default Study on the Non-Rated Land Secured Market in California

Major Comments:

This essay provides a significant contribution, both academically as well as in terms of the municipal marketplace applications, in that it demonstrates that non-rated land secured bonds are comparable, in terms of their creditworthiness or default rates, to other municipal bonds that have B to BBB ratings.

Specifically, the current municipal bond markets, based upon their relative interest rate structures, may not be providing significant recognition to the credit quality non-rated land secured bonds. The non-rated land secured bonds have higher yields than B to BBB bonds, although both have similar default rates, and so they might not be priced appropriately in the marketplace. Consequently, the borrowers that use land secured bonds may be paying higher interest rate costs than their default ratios suggest as being appropriate.

So, to the extent that the municipal marketplace is provided information on the actual default rates for land secured bonds, as demonstrated in this essay, then their relative levels of interest rates may decline, thereby benefiting the Issuers of such bonds, through lower interest rate costs.

Supplemental Comments

Page 2: Some further clarification between curing a Community Facilities District Bond (the missed payment ONLY) as compared to either an Assessment District municipal bond a corporate bond (potentially, an acceleration clause for the entire amount of debt).

Pages 29 & 36: Caption at bottom of graph – far right vs. right hand Y-Axis caption: Clarify # Deals vs. \$ Amount

Page 40: Consider adding a graph vs. just the table.

Page 41: Consider adding a graphs showing default % on land secured vs. municipal B, BB & BBB bonds default %.

General Remark:

Might the default rate for non-rated land secured bonds actually be lower in that the number of non-rated land secured bonds is reduced over time, since land secured bonds for which projects are built/occupied have sufficient increases in their creditworthiness to enable them to be refunded as rated bonds.

Chapter III: Curing Default: A Theoretical Model

Major Comments:

This essay provides a substantial contribution in that it illustrates that when non-rated land secured bonds, which have more than one property owner, go into default, they encounter challenges in curing the default, due to conflicting agendas of the various property owners.

The recognition that partial defaults are so difficult to resolve serves as a fore-warning that when the Special Taxes are initially structured, there should be mechanisms put into place that can later be utilized, in the event of a partial default, to facilitate the resolution of such a default.

Supplemental Comments

Page 1: In recent years, there has been a trend to sell the CFD bonds when the property is owned by builders, who are proceeding with the construction of homes, as compared to developers, who are securing entitlements and grading the property.

(Note: This may be a result of finance teams recognizing the difficulty of curing partial defaults – the risk of a default is reduced when the property moves into the building stage, construction of homes, as compared to the initial development stage, preparation of the land.)

Page 10: Another component of the model may be that the property owner that has paid his/her Special Tax payments in a timely manner may feel that, due to the cross-collateralization of all the properties, that he/she is entitled to be reimbursed for some of his/her overpayments that occurred when the other property owner(s) were in default.

General Remark:

The formal economic analysis is quite informative regarding to the conflicts among the various parties; furthermore, as mentioned in the thesis, other legal maneuvers, such as bankruptcy, may further confound the process.

Chapter IV: Determinants of Default and Redemption on the Non-Rated Community Facilities Bonds in California

Major Comments:

This essay provides a contribution with regards to better understanding the factors that contribute to the defaults of CFD Bonds, primarily the performance of the real estate market as measured by residential and non-residential permits with lags of one year as well as the age of the bonds.

By identifying such factors, Issuers of CFD Bonds are placed in a more informed position about the role of economic factors, and, as such, may utilize more conservative policies if conditions in the near-term, during the initial years following the Bond Issue, are expected to be adverse.

Supplemental Comments

Page 16: A graph of the data would be helpful, with a separate line for each of the issuance years; additionally, overlay a rectangular box covering the years during which building permits issuances were at relatively low levels.

Page 19: The age-factor is of interest because for a CFD that experiences strong development during the first few years; its bonds then becomes candidate for redemptions, with the new bonds having a lower interest rates that, in turn, reduces the interest rate for the property owners, typically homeowners. By comparison, for a CFD that does not initially experience strong development during the first few years, it becomes a stronger candidate for default, especially under adverse economic conditions.

General Remark:

This is a particularly difficult area to analyze, due to the challenges in compiling data on more detailed characteristics of the various Bond Issues, such as their project locations relative to employment centers or their product characteristics, residential vs. commercial-industrial. However, such data are not reported as part of the bond statistics, and so this essay utilizes, to the best of my knowledge, the data that are available.

Concluding Remarks

Therefore, each essay addresses a significant topic: The first essay demonstrates that the actual default rates for non-rated land secured bonds are actually similar to municipal bonds with B to BBB credit ratings. The second essay illustrates that the Special Taxes should initially be structured in a manner that facilitates the resolution of future partial defaults. Finally, the third essay provides Issuers with an understanding of how adverse economic factors can cause Bonds to default, so that they might implement more conservative policies when such conditions are expected to occur.

The essays have a strong potential for publication in academic journals, and, furthermore, they will have a substantial impact on the municipal bond land secured marketplace. Specifically, the essays provide a better understanding of the actual risk of non-rated land secured bonds vs. municipal rated B to BBB bonds, which may lower rates and hence interest rate costs. Furthermore, the essays offer insight on the policies that should be followed for curing partial defaults as well as implementing more conservative policies when adverse real estate conditions are expected to occur.

Finally, my comments are meant to suggest potential modifications for the future publication of these essays in professional journals, rather than current revisions to the thesis.

In conclusion, the thesis demonstrates that the candidate is ready for defense. Furthermore, I would encourage the candidate to pursue the publication of these articles and also to present them at conferences, since they may have a significant impact on how the municipal market perceives the creditworthiness of non-rated land secured bonds.