CALIFORNIA DEBT ADVISORY COMMISSION

GUIDELINES FOR MELLO-ROOS FINANCING

Kathleen Brown
California State Treasurer
and Chair

GUIDELINES FOR MELLO-ROOS FINANCING

October 1991

CALIFORNIA DEBT ADVISORY COMMISSION
915 Capitol Mall, Room 400
P.O. Box 942809
Sacramento, CA 94209-0001
(916) 653-3269

STATE OF CALIFORNIA

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

915 CAPITOL MALL, ROOM 400
P.O. BOX 942809
SACRAMENTO, CA 94209-0001
TELEPHONE: (916) 653-3269
FAX: (916) 654-7440

Steve Juarez
Executive Director

October 1991

On behalf of the California Debt Advisory Commission (CDAC), I am pleased to release *Guidelines for Mello-Roos Financing,* a summary of suggested actions local officials can undertake to enhance their use of Mello-Roos bonds. *Guidelines is* excerpted from *Mello-Roos Financing in California,* a comprehensive review of the Mello-Roos Community Facilities Act of 1982 recently issued by CDAC.

Over the past eight and one-half years, more than $3.2 billion in Mello-Roos special tax bonds have been issued by local governments in California. These bonds have financed the construction of needed public improvements such as schools, roads, freeway interchanges, sewage treatment plants, and a host of other public facilities. The growing reliance of California local governments on Mello-Roos bond financing reflects broader fiscal trends toward increased specialization and greater local responsibility. These trends came about as a result of the voter approval of Proposition 13 in 1978 and declining federal assistance for local infrastructure.

The Mello-Roos Act, however, comes with its share of added responsibilities for local government officials. The precarious nature of land-backed financing necessitates that public officials pay close attention to the credit structure of Mello-Roos bonds. In addition, local officials should be cognizant that excessive overlapping tax rates and inequitable tax burdens may result from the implementation of the Mello-Roos special tax.

The enclosed planning and project evaluation guidelines are intended to assist local officials in addressing their debt management responsibilities. I commend these guidelines to the attention of all local officials.

Sincerely,

KATHLEEN BROWN
California State Treasurer
Chair, California Debt Advisory Commission

California Debt Advisory Commission

The California Debt Advisory Commission is the state's clearinghouse for public debt issuance information. The Commission was created by the California Legislature in 1981 to assist state and local government agencies with the monitoring, issuance, and management of public debt.

The California Debt Advisory Commission members include:

Additional information concernlag this report or
the program of the California Debt Advisory Commission
may be obtained by contacting:

Steve Juarez
Executive Director
California Debt Advisory Commission
(916) 653-3269

GUIDELINES FOR MELLO-ROOS FINANCING

On the surface, local governments would appear to have little to lose from authorizing the formation of Mello-Roos Community Facility Districts (CFDs) and approving the sale of special tax bonds. Mello-Roos financing allows public facilities in developing areas to be installed quickly and limits the financial liability for the bonds to landowners. The fact that Mello-Roos special tax bonds carry more risk than most municipal securities is not a problem, per se, as long as investors are aware of the risk and are compensated accordingly. In that respect, Mello-Roos bonds are similar to other higher risk municipal securities, such as multifamily housing bonds or industrial development bonds.

Unlike multifamily housing bonds and industrial development bonds, however, Mello-Roos special tax bonds represent tax-supported debt, rather than private obligations. Even though local governments bear no direct financial responsibility for Mello-Roos special tax debt, they are responsible for managing the levels of tax-supported debt within their boundaries, including the debt issued by CFDs. The debt capacity of developing areas--or established areas, for that matter--is a finite resource. Municipal debt is, after all, serviced by tax revenues which are in turn paid from the incomes of taxpayers. At some point, if the debt burden reaches excessive levels, taxpayers may become unwilling or unable to pay.

In the lexicon of the rating agencies, Mello-Roos special tax bonds are considered *overlapping debt* because the debt issued by CFDs must necessarily overlap with that issued by other local agencies. To the extent that an issuer's overlapping debt burden is viewed to be excessive, a downgrade could ensue--which would increase the costs of all future bond issuances, not just Mello-Roos special tax bond issuances. Even in the absence of a downgrade, prohibitive levels of overlapping debt could limit the issuer's flexibility in meeting future capital outlay needs. This loss of flexibility makes it important for each Mello-Roos special tax bond issuance to be weighed in the context of a jurisdiction's total infrastructure requirements.

In addition, the negative publicity which surrounds bond defaults argues for maintaining strict issuance and underwriting standards for individual Mello-Roos bond issuances, apart from concerns regarding overlapping debt levels. For all of these reasons, local governments need to exercise caution in approving Mello-Roos debt.

Consequently, the use of Mello-Roos financing should be guided by sound planning and project evaluation guidelines that go beyond the minimum requirements of state law. CDAC suggests these guidelines for local governments to consider as a framework for developing policies on the use of

Mello-Roos financing The planning guidelines apply to cities and counties and focus on the need to integrate decisions concerning the use of Mello-Roos financing into the land use regulatory framework. The project evaluation guidelines apply to all issuers and focus on (1) minimizing credit risk and (2) maintaining reasonable and equitable tax burdens. The policy objectives of these guidelines are briefly described below.

Integrating Mello-Roos Financing Into the Land Use Regulatory Framework. From a planning perspective, Mello-Roos financing is attractive in that it can be used to avoid two common pitfalls of the development process: the unintended congestion of existing facilities and the necessity for subsidies from existing residents. Because of the landowner vote, Mello-Roos financing allows public facilities to be installed concurrently with development. The flexibility permitted in the design of CFD boundaries allows the public costs of development to be isolated to the developing area. And the tax-exempt interest rate may permit facilities to be constructed more cheaply than if the developer had arranged private financing.

However, the planning advantages cited above apply to *individual* local government units addressing the infrastructure demands of growth. Mello-Roos financing also exposes an organizational weakness in the *collective response* of local governments serving developing areas; namely, there is often no coordination of the financial decisions of different local governments supported by the same group of taxpayers. In the absence of coordinated planning, taxpayers are vulnerable to onerous overlapping tax burden. This is especially problematic given the ease with which CFDs can be formed. Developing areas are typically served by the city or county government, one or more school districts, and often one or more special districts. Each of these local government units has the authority to approve the formation of CFDs and to levy special taxes on the same group of taxpayers.

Though each special tax may be imposed in good faith and dedicated to worthwhile projects, the cumulative burden of the special taxes could prove excessive to the taxpayers. And though the burden of overlapping tax rates may eventually exceed the taxpayers' ability to pay, the immediate risk is probably more political than financial in nature. For instance, if angry taxpayers were to lash out in some unpredictable fashion local officials might encounter reduced flexibility in managing their financial affairs.

An appealing response to the problem of overlapping tax rates is the imposition of voluntary or mandatory limitations on the total amount of taxes-including Mello-Roos special taxes--which may be levied on developing areas. In fact, we recommend in the project evaluation guidelines to follow that the total tax burden in developing areas should not exceed two percent of the appraised fair market value of the property upon completion of all public and private improvements. It should be recognized, however, that such limitations can produce an unhealthy competition between local governments for available debt capacity, as each local government may be tempted to grab some of the debt capacity while it is still available. Cities and counties, which control the land use entitlement process, will have a leg up in this competition. The danger is that available debt capacity will be squandered on lower priority facilities which can be phased-in later, leaving the developing area without the resources to address immediate needs.

In certain respects, the problem of overlapping tax rates in developing areas is analogous to the pre-Proposition 13 system of property taxation when each local government set its own property tax rate. When Proposition 13 limited the countywide rate to one percent in 1978, a mechanism was needed to allocate the new, lower rate among the local government units which previously had set their own rates. The Legislature addressed this issue by enacting clean-up legislation (Senate Bill 154 in 1978 and Assembly Bill 8 in 1979) to allocate the one percent countywide rate according to the proportionate share of total property tax revenues collected by each local government in the three years prior to Proposition 13. Since that time, the Assembly Bill 8 property tax allocation formula has been a source of irritation to many local governments that feel wronged by an arbitrary formula that does not account for programmatic responsibilities.

To the extent that local governments voluntarily limit the tax burden in developing areas today, they do so without a formula for allocating the limited debt or tax capacity among the local governments in the service area. The absence of such a formula is desirable from a planning perspective, in that the facility and service needs for development projects will vary on a case-by-case basis. For example, some development projects might require that an expensive drainage problem be corrected before development can proceed. In other cases, school overcrowding might be the major impediment to development. In still other cases, the local government may have redevelopment funds or other revenue sources that can be dedicated to economic development purposes or other policy objectives deemed to be in the community's interest. Even in cases where Mello-Roos special tax bond financing appears to be the appropriate option, specific proposals might not withstand the scrutiny of the project evaluation criteria adopted by the local government.

Because of the disparate fiscal impacts of individual development projects, there is really no reasonable basis for making a determination ahead of time as to how available debt capacity should be allocated among local governments, However, debt capacity is finite and should be viewed as a shared resource by all of the local governments serving the development area. Consequently, balancing the funding requirements of *all* governmental entities should be an important part of land use approval decisions. To the extent that land use decisions are made without appreciation of the comprehensive fiscal impacts, the developing areas may have to live with (1) excessive overlapping tax burdens or (2) inadequate service levels.

The planning guidelines to follow suggest specific policies for integrating Mello-Roos financing decisions into the land use regulatory framework.

Minimizing Credit Risk. A key objective of the project evaluation guidelines is to minimize the credit risks associated with Mello-Roos special tax bonds. Mello-Roos special tax bond financing, along with other land-backed securities, introduces an element of speculative credit risk to the practice of local government finance. If construction and sales do not proceed as planned, the landowner may face difficulties in meeting scheduled debt service payments. The landowner vote, while desirable from a *concurrency* or timing perspective, does not offer the security of a conventional vote. It is not an expression of the community's ability and willingness to pay off the debt. As a practical matter, the landowner vote can be considered as a procedural mechanism by which local governments extend tax-exempt borrowing authority to developers. The expression of community support does not occur until people purchase the developed parcels and assume responsibility for the tax liens on the property.

Local governments need to be concerned about the credit quality of bonds issued by CFDs within their boundaries. Though financial liability for the bonds is limited to landowners, the negative publicity surrounding a default could affect the price that investors would be willing to pay for future bond issuances of the local government, as well as the prices at which its outstanding debt obligations trade on the secondary market.

Maintaining Reasonable and Equitable Tax Burdens. The objective of maintaining reasonable tax burdens in CFDs is best advanced by integrating financing decisions into the land use regulatory process, as described above. In addition, individual proposals for Mello-Roos financing will need to be evaluated to determine the tax burden that will be imposed upon the residents of the CFD. The project evaluation guidelines provide objective criteria for making this determination.

Another important objective of the project evaluation guidelines is to promote an equitable distribution of the tax burden within CFDs. The project evaluation guidelines provide specific recommendations for developing equitable special tax apportionment formulas, while recognizing the need for flexibility under certain conditions.

PLANNING GUIDELINES

All development--residential, commercial and industrial--creates a burden on the community infrastructure. All development proposals must navigate a myriad of government regulations which are intended to minimize the adverse environmental impacts of development and to advance a variety of public policy objectives. Our concerns are limited to the interaction between the land use entitlement process and public finance. The guidelines below suggest that decisions concerning Mello-Roos special tax bond financing should be guided by the notion that the available debt capacity is a shared resource among the local governments serving developing areas.

Establish Financing Policies in the General Plan

> *Cities and counties should establish comprehensive financing policies in their general plans to mitigate the service level impacts of growth, including the impact on schools.*

The general plan of the city or county should outline the community's approach towards the financing of infrastructure for existing areas and new development. In most cases, the benefit principle will serve as the operative model: existing residents will pay for infrastructure that benefits existing areas, and new residents will pay for the infrastructure required in developing areas. The entire community will pay for infrastructure that benefits the entire community. Within these broad categories, costs can be further allocated in proportion to the service demand generated by different land uses.

The financing policies should also establish that it is the intention of the city or county to mitigate the service impacts of development: development approval will be subject to adequate service capacity. The most difficult aspect to the implementation of such a mitigation policy, however, is defining the scope of a community's *service capacity* Should the general plan of the city or county address the service capacities of the other local government units serving development projects, most significantly school districts? In our view, a comprehensive policy toward mitigating the service impacts of growth is the best way to foster cooperation in allocating available debt capacity. Establishing a comprehensive policy legitimizes the funding requirements of all governmental units serving the development project. While the public costs of individual development projects will vary on a case-by-case basis, there is a greater chance of allocating available debt capacity on a priority basis if the total costs arc recognized early in the land use entitlement process. Conversely, it becomes unlikely that available debt capacity will be allocated on a priority basis when local financial planners ignore substantial capital expenditure requirements because they are the responsibility of other agencies.

In addition, the *Mira* and *Hart* decisions offer a compelling case for addressing school capacity issues in the general plan. As a result of these decisions, cities and counties that continue to maintain that the 1986 School Facilities Act preempts their authority to address school capacity issues in their planning documents are vulnerable to legal challenge. By establishing the policy that development approval is subject to adequate school capacity, cities and counties are forced to recognize the full fiscal impact of their land use decisions.

Identify Service Standards in the General Plan

> *Cities and counties should include level of service (LOS) standards in their general plans for individual program areas.*

After establishing the policies outlined above, the next step is to adopt level of service (LOS) standards for the individual program areas. LOS standards permit local planners to estimate the service impact of development projects and to demonstrate that any fees or exactions imposed meet the nexus requirements specified in current law.

The operative standards for school facilities should be the cost and area standards promulgated by the State Allocation Board (SAB). Before the city or county adopts a policy of mitigating the school capacity impacts of growth, the school district itself should adopt a facility master plan consistent with the local general plan and the SAB facility standards. A mutual agreement on the SAB standards can help avoid arguments over the *gold plating of* school facilities which sometimes plague intergovernmental relations. Placing the standards in the general plan demonstrates the commitment to mitigating the service impacts of growth according to specified criteria.

Distribute Costs on a Project-by-Project Basis

> *Cities and counties should distribute growth-induced infrastructure costs on a project-by-project basis.*

The financing policies establish the community's general approach towards who will pay for public facilities in developing areas, and the LOS standards provide the basis for measuring the service level impact of development proposals. But the public costs of individual development projects must ultimately be distributed on a project-by-project basis.

Though we cannot offer a definitive approach to the question of when Mello-Roos financing should be used, it is possible to outline an approach toward developing the financing plan for individual development projects which follows from the discussion above. Once again, the infrastructure costs of development will vary on a case-by-case basis. For some projects, a generic application of developer exactions and/or Mello-Roos financing will generate sufficient revenues. In other cases, the infrastructure costs will exceed the normal parameters. However, if one accepts the premise that LOS standards should be maintained in the face of development pressures and that debt capacity is a finite resource, that leaves only two sources available for addressing any *residual* costs of growth: the developers themselves and the broader community.

Whether such costs are distributed narrowly or broadly will depend upon the community's application of the financing policies adopted in its general plan to the situation at hand. For some types of facilities, the community will decide that the needed infrastructure will not produce communitywide benefits and, therefore, the costs should be isolated on the development. Though development fees are limited by local ordinances and state statutes, additional fees can be imposed when individual development decisions result in unmitigated service impacts. Under authority of California Environmental Quality Act, unmitigated service level impacts can be identified as *adverse environmental effects* in the draft or final EIR which must be avoided (by denying or redesigning the project) or mitigated (through the payment of a fee). As noted above, the *Mira* and *Hart* decisions open the way for cities and counties to impose school impact fees above those authorized by the 1986 School Facilities Act.

The feasibility of broader community participation in financing capital improvements is limited by the two-thirds approval requirement for local general obligation bonds. If a simple majority approval requirement for local general obligation bonds is ultimately approved on the statewide ballot, funding decisions for facilities of communitywide benefit would likely be put to referendum more frequently. Paradoxically, school facilities--which are the subject of such controversy in the area of developer fees--might prove to be the most likely candidate for local general obligation bond financing because of the unique nature of educational benefits.

Relying more on local general obligation bonds to address the school capacity demands of growth would represent a policy compromise between state funding (which may be equitable but has proven to be impractical), and entirely localized funding through developer fees and landowner-approved Mello-Roos financing (which is practical but may be inequitable). To the extent that a simple majority voter approval requirement for local general obligation bonds results in broader participation by the general community in financing school facilities, more debt capacity in developing areas could be freed op for other purposes. Realistically, local general obligation bond proposals would probably fare better with the voters in cases in which growth is diffused throughout the school district, as opposed to cases in which the demand is caused by one or two large scale development projects.

Under the acquisition-based assessment practices instituted by Proposition 13, however, the expanded use of local general obligation bond financing would place a disproportionate share of the tax burden on more recent homebuyers, by any objective measure of tax equity. By contrast, moving toward a simple majority vote approval for Mello-Roos special tax bonds could lead to a more equitable distribution of the tax burden than would occur under majority voter-approved general obligation bonds. Insofar as the Mello-Roos Act does not specify how the special tax should be apportioned, the matter of equity would be left to the discretion of the local agency forming the CFD.

A simple majority approval requirement for Mello-Roos special tax bonds would permit public facilities to be phased-in more easily in developing areas after a certain amount of development has occurred. Whether the costs of those facilities would be distributed narrowly or broadly would, of course, depend upon the boundaries of the CFD. In the Elk Grove Unified School District, for example, the CFD was designed to be coterminous with the school district's boundaries, which resulted in a broader distribution costs than if the CFD had been isolated to developing areas only. But a simple majority approval for Mello-Roos special tax bonds would not necessarily result in the broader distribution of tax burdens.

In the present fiscal environment, however, local governments may face development pressures to relax LOS standards or to overextend the debt capacity of developing areas. To help avoid such problems, the following section offers guidelines for evaluating proposals for Mello-Roos financing.

PROJECT EVALUATION GUIDELINES

:

The project evaluation guidelines outline both a procedural approach toward evaluating requests for Mello-Roos financing and criteria for evaluating individual proposals. The guidelines ate based upon our research conducted in preparation of this report, which includes a review of several Mello-Roos policies adopted by local governments throughout the state. Some of the individual policies we reviewed contained more restrictive guidelines than are recommended here. On the other hand, we are aware that many local governments throughout the state have not adopted any guidelines. Consequently, we attempted to take a *middle ground* approach which would be of value to those communities with well-established project evaluation policies, as well as to those areas which may be considering policies for the first time.

Establish a Project Review Committee

> *Local agencies should establish project review teams to scrutinize and assess developer applications for new Mello-Roos CFDs.*

Cities and counties should establish a Project Review Committee to review developers' applications for permission to use tax-exempt bond financing for development projects (the necessity for school districts and special districts to establish such committees will depend upon the degree to which such requests are received by these districts). Membership in this Review Committee should be determined by the local governing board, depending on the experience and willingness of available staff, but likely candidates should include representatives from the Public Works Department, the Planning Department, the Assessor's Office, the Auditor/Controller's Office or Finance Department, the County Administrator or City Manager's Office, the City Attorney or County Counsel, and the Treasurer Tax Collector.

The Review Committee should conduct an independent review of each public financing proposal according to the criteria outlined below. In addition, the Review Committee should select all of the professionals necessary to conduct the transaction (bond counsel, underwriter, financial advisor, appraiser, special tax consultant or assessment engineer, and absorption study consultant). The committee should consider requests from the applicant regarding the selection of professionals, but the consent of the applicant should not be required.

Due to the degree of risk associated with Mello-Roos special tax bond financings, the selection of competent, ethical professionals is imperative. The credit risk associated with individual Mello-Roos financing proposals cannot necessarily be ascertained in a *cookbook* fashion, the guidelines listed below notwithstanding. The judgment of experienced professionals will be needed to assess the risk of individual proposals and to develop appropriate responses.

Value-to-Debt Ratio

> *Local agencies should require that land within a CFD have a value-to debt ratio of at least 3:1.*

The ultimate security for Mello-Roos special tax and special assessment improvement bonds is the value of the land itself, including the value of existing improvements and any improvements to be financed through the bond issuance. In the event of a default, foreclosure proceedings will commence and the property will eventually be sold to pay off the outstanding delinquent tax lien. The ratio between the value of the land and the improvements to the amount of outstanding debt on the property is called the value-to-debt ratio (this ratio is also referred to as the *value-to-lien* ratio). To protect credit quality, local governments should require a minimum value-to-debt ratio of 3:1. The valuation should be based on a bulk sale evaluation conducted by an MAI appraiser. The bulk sale evaluation assumes the immediate sale of all properties under common ownership, which would be the situation under judicial foreclosure proceedings. The debt total should include any prior or pending special tax or improvement liens.

Special Tax Limitation

> *Local governments should set maximum special tax rates for landowner-approved financings at one percent (1%).*

Establishing tax rate limitations can be an exercise in wishful thinking. People want low taxes and high service levels. At the heart of the debate over taxes is a trade-off between public and private consumption. In a democratic society, this trade-off is decided either directly, through referendum, or indirectly, through the budgetary actions of elected officials. Yet, decisions to use landowner-approved Mello-Roos financing represent something of a twist on the traditional mechanisms of public choice, as local officials must decide questions of tax and spending policy for developing areas without the input of the ultimate residents of those areas. Given the degree of risk associated with such decisions, it would seem prudent not to overburden developing areas with landowner-approved Mello-Roos special taxes. At some point, the tax burden may affect the marketability of the properties, which could, in turn, cause problems for investors, landowners, and local governments alike. If the buyers of properties in these development projects move in and decide to tax themselves at higher rates, so be it.

Consequently, the maximum special tax rate for landowner-approved financings should not exceed **one percent** (1%) of the anticipated fair market value, or assessed value, of each improved parcel upon completion of all public and private improvements. The special tax should not cause the total tax burden on residential property to exceed **two percent** (2%) of the anticipated fair market value of each improved parcel upon the completion of all public and private improvements. The total tax burden calculation should include projected ad valorem taxes and any overlapping assessments and special taxes.

Special Tax Inflators

> *Local governments should limit annual increases in the maximum special tax to two percent (2%).*

Special tax formulas should also promote stable and predictable tax liabilities, particularly for residential properties. Fluctuating special tax rates make it difficult for homeowners to plan their finances. Special tax formulas should limit escalator rates allowing annual tax increases in the maximum special **tax to two percent (2%) annually.**

In the event that special tax payments are supporting the provision of services, rather than capital expenditures, ongoing costs will be affected by the rate of inflation. Consequently, a higher inflator, such as the state and local deflator for goods and services, is appropriate.

Special Tax Coverage **r**

Local agencies should set the maximum special tax at a minimum of 110 percent of expected annual debt service.

To provide added security to the bonds, the maximum special tax should generate at least 110 percent of projected annual gross debt service on the bonds. The actual coverage required will depend on the number of landowners and their financial strength. The exact coverage should be determined through consultation with the professionals working on the transaction.

Capitalized Interest Account

Local agencies should establish a capitalized interest account if it will improve the credit quality of the bonds and result in lower borrowing costs.

Decisions to capitalize up to two years of interest into the bond issuance should be made on a case-by-case basis. The decision rule should be that a capitalized interest account will improve the credit quality of the special tax bonds and result in lower borrowing costs, benefiting all taxpayers in the CFD. From a negotiating perspective, local government should recognize that the capitalized interest account provides a source of subsidy to developers because the debt service being covered by such an account in the early stages of construction would otherwise be the responsibility of the developer.

Tax Rates on Developed and Undeveloped Land

Local governments should tax developed and undeveloped land at the same rates.

The special tax formulas should promote an equitable distribution of the tax burden between developed and undeveloped land. The practice of taxing undeveloped land at lower rates than developed land can transfer some of the business risk associated with the development process from developers to home buyers. To the extent that properties are not developed as quickly as anticipated at the time of bond issuance, more of the tax burden may be shifted to the early home buyers in the development project. Moreover, the existence of a differential between developed and undeveloped land special tax rates may not provide developers with an adequate financial incentive to form improvement areas and to phase-in the construction of public facilities when possible. It does not seem equitable to require early home buyers in a development project to subsidize the construction of public facilities from which they will derive no real benefit. If local officials believe such a subsidy to be necessary, it may be more appropriate to pay for it through a broader-based tax than a special tax levied on developed property within a CFD.

As a general policy, developed and undeveloped land should be taxed at the same rates. The special tax rates should correspond to the adopted land use designations for each parcel. Undeveloped land should be taxed at rates equivalent to tax rates levied on developed properties of the same land use designation. There may be a justification, in some cases, for taxing developed land at higher rates to pay for the early installation of large infrastructure items, such as water supply systems and sewage treatment plants that must be installed with significant excess capacity because of the economies of scale in construction. Local officials may surmise that it is equitable to charge early residents more for the immediate availability of service.

While the practice of taxing undeveloped land at lower rates may improve the credit quality of the special tax bonds in some cases, it should be recognized that the Mello-Roos Act provides other security features which, in effect, already provide a subsidy to the owners of undeveloped land. In addition, local officials have the option of requiring credit enhancements to secure the special tax payments from large property owners.

Disclosure of Special Tax Lien

New home buyers within CFDs should be provided information regarding how special tax rates are set.

In addition to disclosing the annual amount of the maximum special tax, as required by law, basic information concerning the special tax formula should be disclosed to the homebuyer. Specifically, the homebuyer should be made aware of whether or not the special tax will be levied at the same rates for developed and on developed properties. The local government approving the formation of the CFD may wish to develop its own form for this purpose, to be signed by the homebuyer prior to the close of escrow.

Bond Reserve Fund

Local governments should set the bond reserve fund at 10 percent of the principal amount of the bonds or the maximum allowed by law.

In the event that any portion of the special tax becomes delinquent, it will be necessary to draw from a reserve fund established from proceeds of the bond sale. The reserve fund should be set at 10 percent of the principal amount of the bonds or the maximum allowed by law. (A lower reserve fund of 5 percent is appropriate for localities participating in the *Teeter Plan*, under which the county assumes the responsibility for tax payments in return for all interest and penalties on delinquent payments.) Again, the exact amount should be determined in consultation with the professionals working on the transaction.

Treatment of Delinquencies

Local governments should adopt foreclosure covenants which provide maximum flexibility.

In developing a policy on the treatment of delinquencies, local officials must balance the objectives of tax equity and credit quality. Many special tax formulas allow delinquencies to be added into the revenue requirement for the subsequent year, raising the tax burden for taxpayers who pay their special taxes on time. When the delinquencies are finally paid in full, with penalty, the revenue requirement for the following year is lowered, thereby lowering the special tax rates for all taxpayers--even those that were delinquent. The amount by which the special tax rates are reduced once delinquencies are paid in full may not be sufficient to compensate nondelinquent taxpayers for the *time-value* of the money they had to put up to cover the delinquencies.

The most equitable response to this problem would be to vigorously pursue foreclosure proceedings on all delinquencies and to draw on the reserve fund to make up any deficiencies. Therefore, special tax rates would not have to be raised for current taxpayers in order to cover delinquencies, unless the balance in the reserve fund was insufficient. Adopting such a policy, however, could create credit problems, insofar as investors view the ability to raise special tax rates (up to the maximum permitted rate), *before lapping the reserve fund,* to be an important credit feature of Mello-Roos special tax bonds. In the future, the issuer may wish to purchase bond insurance or request a credit rating once the development project becomes partially built out, to save on interest costs. Restrictive foreclosure covenants in the bond documents may preclude the issuer from this course of action.

Moreover, foreclosing special tax liens on *widows and orphans* (i.e., especially vulnerable taxpayers) may create public relations problems that far outweigh the benefits of a strict foreclosure policy. More specifically, if a residential property delinquency of small dollar amount and short duration does not materially affect the credit quality of the bonds, why immediately pursue foreclosure?

A good middle ground is to develop a foreclosure covenant which takes into account (I) the amount of the delinquency; (2) the duration of the delinquency; and (3) the condition of the reserve fund. The specific details of the covenant will depend upon the size and duration of the bond issue along with the concentration of the special tax base at the time of bond issuance. The purpose of the policy is to foreclose when necessary to protect the credit quality of the bonds and to be otherwise flexible.

Finally, another practice which can help to avoid tax rate fluctuations on residential properties is to specify that the interest earnings from the bond reserve fund will be used to cover delinquencies. This reduces the need to both raise special tax rates to cover delinquencies and initiate foreclosure proceedings.

SUMMARY

The Mello-Roos Act provides local governments with a powerful financing tool which allows public facilities to be installed concurrently with development, while isolating the costs of doing so to the developing area. But local governments need to exercise caution in their use of Mello-Roos financing. as land-backed securities are inherently risky and may pose an excessive burden on taxpayers when coupled with other taxes and assessments. These guidelines are intended to assist local officials in taking advantage of the benefits of Mello-Roos financing while minimizing the associated risks. The planning guidelines outlined above apply to cities and counties and suggest how decisions concerning Mello-Roos financing can be integrated into the land use entitlement process. Specifically, these guidelines recommend that cities and counties establish financing policies and identify service standards in their general plans. The policies and standards should be comprehensive, covering all of the local government units serving the development area, including school districts. These guidelines also suggest that the infrastructure costs of individual development proposals should be distributed on a project-by-project basis and in accordance with financing options that are available and appropriate.

These guidelines recommend that all local governments adopt policies specifying the conditions under which they will extend the option of Mello-Roos special tax financing to developers. The project evaluation guidelines outlined above provide a reasonable framework for developing local policies. The goal of the project evaluation guidelines is to minimize credit risk and to protect taxpayers-from excessive or inequitable tax burdens. Because of the inherent risk of land backed securities, the only way to effectively preclude such risk would be to refrain from issuing landowner-approved special tax bonds at all. But the usefulness of Mello-Roos financing in addressing planning objectives makes it an attractive option, if the risks can be kept within reason.