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MEMORANDUM**To:** Board of Directors**Date:** March 7, 2003*Ken***From:** Ken Carlson, Director of Financing
CALIFORNIA HOUSING FINANCE AGENCY**Subject:** Actions of the California Debt Limit Allocation Committee

At the January Board meeting, I shared some estimates of the amount of private activity bond volume cap that we could expect from CDLAC this year for the Homeownership Program. Since then, based on actions by CDLAC at its January 15 meeting, these numbers have been refined and are as follows:

"Carryforward" from amounts left over in 2002	\$139,255,188
2003 "Fair Share" volume cap set aside for CalHFA	
To be received 3/26/03	\$121,186,203
To be received 6/25/03	<u>\$121,186,202</u>
Total 2003 allocation	<u>\$242,372,405</u>
Total for Homeownership	\$381,627,593

In comparison, during 2002 CalHFA received the following amounts:

Carryforward from 2001	\$ 73,775,798
"Fair Share" allocation	\$266,400,000
Extra Credit Teacher Program allocation	<u>\$ 95,000,000</u>
Total	\$435,175,798

The table attached (prepared by the CDLAC staff) provides a complete comparison of 2002 reservations versus reservations proposed for 2003. Note that the amounts reserved for housing in 2003 have been increased over those reserved in 2002.

Attachment

CALIFORNIA DEBT LIMIT ALLOCATION COMMITTEE

Comparison of 2002 Pool Reservations and Proposed 2003 Pool Reservations

The State Ceiling for 2002 was \$2,587,584,750. The 2003 State Ceiling is \$2,633,702,475, based on the State's of 35,116,033 in 2002 (35,116,033 x \$75 = \$2,633,702,475). The 2003 State Ceiling is 1.8% larger than the 2002 Ceiling.

	<u>2002 Pool Reservations</u>	<u>% of Cap</u>	<u>Proposed 2003 Pool Reservations</u>	<u>% of Cap</u>
HOUSING				
Multifamily-General	\$925,000,000	35.7%	\$968,702,475	36.8%
Multifamily-Mix'd Inc.	\$378,000,000	14.6%	\$418,000,000	15.9%
Multifamily-Rural	\$40,000,000	1.5%	\$50,000,000	1.9%
Multifamily Subtotal:	<u>\$1,343,000,000</u>	51.9%	<u>\$1,436,702,475</u>	54.6%
Single-Family-CalHFA	\$266,400,000	10.3%	\$242,372,405	9.2%
Single-Family-Locals	\$340,184,750	13.1%	\$381,627,595	14.5%
Single-Family-Bonus	\$0	0.0%	\$0	0.0%
Single-Family Subt:	<u>\$606,584,750</u>	23.4%	<u>\$624,000,000</u>	23.7%
Extra Credit Program	<u>\$125,000,000</u>	4.8%	<u>\$100,000,000</u>	3.8%
<i>Housing Total:</i>	<u>\$2,074,584,750</u>	80.2%	<u>\$2,160,702,475</u>	82.0%
NON-HOUSING				
Indust. Dvlpmnt. Projects	\$85,000,000	3.3%	\$45,000,000	1.7%
Energy Fin. Prog.	\$30,000,000	1.2%	\$30,000,000	1.1%
Equip. Only Prch.Prog.	\$10,000,000	0.4%	\$0	0.0%
Small Business Prog.	\$15,000,000	0.6%	\$17,000,000	0.6%
Indust. Dvlpmnt. Subt:	<u>\$140,000,000</u>	5.4%	<u>\$92,000,000</u>	3.5%
Exempt Facility	\$220,000,000	8.5%	\$226,000,000	8.6%
Student Loan	<u>\$153,000,000</u>	5.9%	<u>\$155,000,000</u>	5.9%
<i>Non-Housing Total:</i>	<u>\$513,000,000</u>	19.8%	<u>\$473,000,000</u>	18.0%
GRAND TOTAL	<u>\$2,587,584,750</u>	100.0%	<u>\$2,633,702,475</u>	100.0%

1. CalHFA received 2002 carryforward allocation, effectively increasing its 2003 allocation. To maintain 50/50 split required Procedures, Local Issuers allocation is increased by an amount equal to 1/2 of the carryforward amount.

MEMORANDUM

To Board of Directors

Date: March 6, 2003

Ken

Ken Carlson, Director of Financing

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: REPORT OF BOND SALE
HOME MORTGAGE REVENUE BONDS 2003 SERIES A

On January 30th we issued \$295.3 million of taxable short-term LIBOR indexed bonds. These bonds were issued under the Home Mortgage Revenue Bonds indenture to preserve tax-exempt authority resulting from bond principal retirements on February 1st. The bonds were issued in variable rate form and the rate is reset quarterly based on an index. The initial rate was set at 1.39%. The bonds are insured and were purchased by the Federal Home Loan Bank of San Francisco (FHLB). The proceeds are invested in the State's Surplus Money Investment Fund, currently at a rate of about 1.92%.

Where we would normally issue Drawdown Bonds to preserve tax-exempt issuance authority, we chose to issue short-term indexed bonds since we were able to invest the proceeds at a rate higher than the rate on the bonds allowing us to earn positive arbitrage on the transaction, as opposed to the Drawdown Bonds where we break even.

While the bonds have a two year maturity, the Agency has the right to redeem the bonds on August 1, 2003 and quarterly thereafter. The FHLB has the right to tender the bonds on February 1, 2004 and quarterly thereafter. Each of our current issues of tax-exempt single family bonds will act as a refunding of a like portion of these bonds.

2005

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MEMORANDUM

To Board of Directors

Date: March 6, 2003

Ken

From: Ken Carlson, Director of Financing
CALIFORNIA HOUSING FINANCE AGENCY

Subject: REPORT OF BOND SALE AND INTEREST RATE SWAP AGREEMENTS
HOME MORTGAGE REVENUE BONDS 2003 SERIES BCD

On January 23rd we set swap rates for \$116.25 million of tax-exempt variable rate bonds. The total bond issue, including \$38.75 million of unswapped taxable variable rate bonds, is \$155 million. The transaction proceeds will be used to fund approximately 1,000 new loans with rates expected to range from 4.25% to 5.25%.

As described in previous reports, the proportion of taxable bonds blended into our structures has declined as we try to minimize our cost of funds in order to keep our mortgage rates competitive with falling market rates. When rates were higher 12 months ago, we were able to structure as much as 50% of each transaction as taxable bonds. Currently, we find that we can structure only 25% of each transaction as taxable bonds.

As expected, we were again faced with very low short-term investment rates. As we wait for our lenders to send us loans for purchase, our bond proceeds are invested at rates significantly below our cost of funds. Therefore, we again decided to delay the delivery of a portion of the bonds and delay the commencement of the swaps until a time when most of the loans would be originated.

This is the first time that we have structured a fully variable rate single family transaction to provide new lending capital. A large portion of each transaction over the past several years has been issued in variable rate form but this is the first time we have determined that issuing some fixed rate debt was not economically beneficial to the structure.

The bonds were structured in three series as shown on the table below. The \$25 million Series B bonds are taxable variable rate LIBOR indexed bonds that were purchased by the Federal Home Loan Bank of San Francisco. The \$13.75 million Series C bonds are taxable auction rate bonds. The \$116.25 Series D Bonds are tax-exempt variable rate demand obligations with liquidity provided by Dexia Credit Local, a Belgian Bank that is the parent company for the bond insurer FSA.

We have arranged interest rate swaps to provide a fixed rate cost of funds for the Series D Bonds. The interest rate swaps are structured with declining notional amounts that match the expected amortization of the corresponding variable rate bonds. A portion of the interest rate swap for the Series D Bonds allows for par termination beginning in year two, in the event of fast prepayments on the loans.

SERIES	B	C	D
\$ Amount	\$25,000,000	\$13,750,000	\$116,250,000
Type of Bonds	Indexed Floaters	Auction Rate	VRDO
Tax Treatment	Taxable	Taxable	AMT
Maturities	2027	2033	2022 & 2033
Average Life	3.15 yrs.	3.88 yrs.	9.90 yrs. & 22.96 yrs.
Interest Rates	Variable	Variable	Variable
Reset Frequency	Quarterly	Every 28 days	Weekly
Floating Rate Swap Formula	N/A	N/A	60% of LIBOR + 26 bps.
Swap Rates	N/A	N/A	3.13% & 3.775%
Bond Delivery Date	2/27/03	2/27/03	4/10/03
Swap Start Date	N/A	N/A	4/10/03
Credit Rating	Aaa/AAA	Aaa/AAA	Aaa/A-1+ AAA/VMIG-1
Bond Insurer	FSA	FSA	FSA

MEMORANDUM**To:** Board of Directors**Date:** March 6, 2003*Ken***From:** Ken Carlson, Director of Financing
CALIFORNIA HOUSING FINANCE AGENCY**Subject:** UPDATE ON VARIABLE RATE BONDS AND INTEREST RATE SWAPS

The following report describes our bond and swap positions as of March 1. It takes into account bond pricings and interest rate swap agreements already agreed to even if actual issuance or swap commencement takes place on a later date. Since the previous Board meeting, we have issued or contracted to issue \$450 million of new bonds, all of which are variable.

Variable Rate Debt Exposure

The total amount of CalHFA variable rate debt will now be \$4.5 billion, 59% of our \$7.7 billion of total indebtedness. As shown in the table below, our "net" variable rate exposure is \$688 million, 8.9% of our indebtedness. The net amount of variable rate bonds is the amount that is neither swapped to fixed rates nor directly backed by complementary variable rate loans or investments.

VARIABLE RATE DEBT
(*\$ in millions*)

	Tied Directly to Variable Rate <u>Assets</u>	Swapped to <u>Fixed Rate</u>	Not Swapped or Tied to Variable Rate <u>Assets</u>	Total Variable <u>Rate Debt</u>
Single Family	\$708	\$2,632	\$573	\$3,913
Multifamily	<u>10</u>	<u>508</u>	<u>115</u>	<u>633</u>
Total	\$718	\$3,140	\$688	\$4,546

Our net exposure has slightly declined since one year ago when it was \$697 million and 9.2% of our indebtedness. Two years ago it was \$517 million and 7% of our indebtedness; three years ago it was \$411 million and 6.75%.

2009

As discussed in each previous report, our \$688 million of net exposure provides a useful internal hedge against today's low interest rate environment, where we are experiencing low short-term investment rates and fast loan prepayments. For example, interest rates for the State Treasurer's investment pool, where we invest our bond proceeds, have now fallen to 1.95%. In addition, the high incidence of single family loan prepayments since early in 2001 has kept our loan portfolio from expanding in spite of our \$1 billion annual new production. However, debt service savings on our unswapped variable rate bonds helps to offset the economic consequences of low investment rates and high prepayments. As an example, the interest rates on our unswapped taxable variable rate bonds are currently in the 1.40% - 1.55% range, levels far lower than we ever imagined.

The table below summarizes this risk position as of March 1.

NET VARIABLE RATE DEBT

(\$ in millions)

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
Short average life	\$133	\$267	\$400
Long average life	<u>98</u>	<u>190</u>	<u>288</u>
TOTALS	\$231	\$457	\$688

Interest Rate Swaps

Currently, we have arranged a total of 69 swaps with eight different counterparties for a combined notional amount of \$3.14 billion and expect to enter into another \$150 million of swaps during March. These interest rate swaps generate significant debt service savings in comparison to our alternative of issuing fixed-rate bonds. This savings will help us continue to offer exceptionally low interest rates to multifamily sponsors and to first-time homebuyers. The table below provides a summary of our notional swap amounts.

INTEREST RATE SWAPS

(\$ in millions)

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
Single family	\$1,200	\$1,432	\$2,632
Multifamily	<u>508</u>	<u>0</u>	<u>508</u>
TOTALS	\$1,708	\$1,432	\$3,140

The table below shows the diversification of our swaps among the eight firms acting as our swap counterparties. Note that our swaps with Lehman Brothers, Bear Stearns, and Goldman Sachs are with highly-rated structured subsidiaries that are special purpose vehicles used only for derivative products. We have chosen to use these subsidiaries because the senior credit of those firms is not as strong as that of the others. Note that with our most recent swaps with Merrill Lynch we are benefiting from the credit of their triple-A structured subsidiary.

SWAP COUNTERPARTIES

<u>Swap Counterparty</u>	<u>Credit Ratings</u>			<u>Notional Amounts Swapped (\$ in millions)</u>	<u>Number of Swaps</u>
	<u>Moody's</u>	<u>S & P</u>	<u>Fitch</u>		
Merrill Lynch Capital Services Inc.					
Guaranteed by:					
Merrill Lynch & Co.	Aa3	A+	AA-	\$ 910.5	18
MLDP, AG	Aaa	AAA	AAA	121.1	3
Salomon Brothers					
Holding Company Inc.	Aa1	AA-	AA+	578.7	13
Lehman Brothers					
Derivative Products Inc.	Aaa	AAA	NR	575.0	16
Bear Stearns					
Financial Products Inc.	Aaa	AAA	NR	560.0	9
Goldman Sachs Mitsui Marine					
Derivative Products, L.P.	Aaa	AA+	NR	169.6	4
UBS AG (Union Bank of Switzerland AG)	Aa2	AA+	AAA	99.6	2
JPMorgan Chase Bank	Aa3	AA-	AA-	96.8	2
Bank of America, N.A.	Aa1	AA-	AA	<u>29.1</u>	<u>2</u>
				\$3,140.4	69

Note that, with interest rate swaps, the "notional amount" (equal to the principal amount of the swapped bonds) itself is not at risk. Instead, the risk is that a counterparty would default and, because of market changes, the terms of the original swap could not be replicated without additional cost.

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Because all of our swaps have been entered into to establish “synthetic” fixed rates for our variable rate bonds, we receive floating rate payments from our counterparties in exchange for a fixed rate obligation on our part. In today’s market, with very low short-term rates, the net periodic payment owed under our swap agreements is from us to our counterparties. As an example, on our February 1, 2003 semiannual debt service payment date, we made a total of \$47.5 million of net payments to our counterparties. Conversely, if short-term rates were to rise above the fixed rates of our swap agreements, then the net payment would run in the opposite direction, and we would be on the receiving end.

Basis Risk

All of our swaps contain an element of what is referred to as “basis risk” – the risk that the floating rate component of the swap will not match the floating rate of the underlying bonds. This risk arises because swap floating rates are based on indexes, which consist of market-wide averages, while bond floating rates are specific to the individual bond issue.

Periodically, the divergence between the two floating rates widens, as market conditions change. Some periodic divergence was expected when we entered into the swaps. In today’s very-low-rate market, we have encountered one such divergence that is worth noting as it pertains to our LIBOR-based swaps used in conjunction with the Agency’s tax-exempt variable rate bonds. Based on a conservative reading of historic relationships between short-term tax-exempt and taxable rates, we chose to enter into many swaps at a ratio of 65% of LIBOR. LIBOR, the London Inter-Bank Offered Rate, is the market benchmark taxable floating rate index. These percentage-of-LIBOR swaps have afforded us with excellent liquidity and great savings compared with other alternatives.

With short-term rates at historic lows and with an increased market supply of tax-exempt variable rate bonds, the historic relationship between tax-exempt and taxable rates has not maintained itself. For example, during 2002 and to date in 2003 the average ratio has been 77%.

When the BMA/LIBOR percentage is very high – as it is today – the swap payment we receive falls short of our bond payment, and the all-in rate we experience is somewhat higher. The converse is true when the percentage is low. In response to this recent anomaly, we and our advisors have looked for a better formula than a flat 65% of LIBOR. After considerable study of California tax-exempt variable rate history, we have settled on a new formula (60% of LIBOR plus 0.26%) that results in comparable fixed-rate economics but performs better when short-term rates are low and the BMA/LIBOR percentage is high.

Risk of Changes to Tax Law

For an estimated \$1.27 billion of the \$1.7 billion of tax-exempt bonds swapped to a fixed rate, we remain exposed to certain tax-related risks, another form of basis risk. In return for significantly higher savings, we have chosen through these interest rate swaps to retain exposure to the risk of changes in tax laws that would lessen the advantage of tax-exempt

2012

bonds in comparison to taxable securities. In addition, we bear this same risk for \$247 million of our tax-exempt variable rate bonds which we have not swapped to a fixed rate. Together, these two categories of variable rate bonds total \$1.52 billion, less than 20% of our \$7.7 billion of bonds outstanding. This risk of tax law changes is the same risk that investors take every time they purchase our fixed-rate tax-exempt bonds.

Amortization Risk

Our interest rate swaps (and the underlying bonds) amortize over their lives based on assumptions about the receipt of prepayments, and the single family transactions which include swapped bonds have been designed to accommodate prepayment rates between two and three times the "normal" rate. In other words, our interest rate swaps have fixed amortization schedules that can be met under what we have believed were sufficiently wide ranges of prepayment speeds. Unfortunately, when market rates fell to unprecedented levels, we started receiving more prepayments than we ever expected.

Since January 1, 2002, we have received \$1.6 billion of prepayments. Of this amount, approximately \$300 million is "excess" to swapped transactions we entered into in 2000 and 2001. In other words, our current loan portfolios for these 2000 and 2001 bond transactions have shrunk to amounts that are \$300 million less than the current "notional" amounts of the interest rate swaps. While these swaps will continue to amortize according to their own schedules, we estimate that the excess may grow to \$500 million this year or next unless market rates rise and prepayments start to slow down.

There are several strategies for dealing with these excess prepayments: they may be reinvested, used for the redemption of other (unswapped) bonds, or recycled directly into new loans. Alternatively, we could make termination payments to our counterparties to reduce the notional amounts of the swaps, but this alternative appears to be the least attractive economically.

Currently we are reinvesting the \$300 million of excess with the banks that originally provided us, for each transaction, with fixed-rate "float" agreements at what seem like high rates today. Most of these agreements, however, were written to limit the amount of time that we could reinvest moneys; in these cases the reinvestment of the excess enables us to put off implementing longer-term strategies that are likely to be less economic.

We believe that the best long-term strategy will be eventually to recycle the excess prepayments into new CalHFA loans. Of course, this means that we will be bearing the economic consequences of replacing old 7% to 8% loans that have paid off with new loans at the rates that will be current at the time we start recycling. If we start recycling today, that means loans with rates ranging from 4.25% to 5.25%. Fortunately, however, our capacity to take on prudent amounts of net interest rate risk and take advantage ourselves of today's very low short-term borrowing rates enables us to offset some of the economic consequences of recycling at low rates.

In addition, to the extent we recycle excess prepayments into new loans, we may reduce the size or number of new bond transactions.

Types of Variable Rate Debt

The table below shows our variable rate debt sorted by type, i.e., whether auction rate, indexed rate, or variable rate demand obligations (VRDOs). Auction and indexed rate securities cannot be "put" back to us by investors; hence they typically bear higher rates of interest than do "put-able" bonds such as VRDOs.

TYPES OF VARIABLE RATE DEBT
(*\$ in millions*)

	Auction Rate & Similar <u>Securities</u>	Indexed Rate <u>Bonds</u>	Variable Rate Demand <u>Obligations</u>	Total Variable Rate <u>Debt</u>
Single Family	\$174	\$1,889	\$1,850	\$3,913
Multifamily	<u>0</u>	<u>0</u>	<u>633</u>	<u>633</u>
Total	\$174	\$1,889	\$2,483	\$4,546

Since September of 2000 we have been able to sell all of our taxable single family variable rate bonds to the Federal Home Loan Banks. Fifteen different issues totaling \$1.46 billion have been purchased by the San Francisco FHLB, and another issue of \$70 million was purchased by the Topeka FHLB. These bonds have all been designed as indexed-rate securities. In addition, our \$328 million of currently outstanding drawdown bonds are indexed-rate securities.

Liquidity Providers

The table on the following page shows the financial institutions providing liquidity in the form of standby bond purchase agreements for our VRDOs. Under these agreements, if our variable rate bonds are put back to our remarketing agents and cannot be remarketed, these institutions are obligated to buy the bonds. For the next one or two single family transactions we expect Dexia Credit Local, a highly-rated Belgian bank, to provide liquidity as they have done for the previous two transactions. Fannie Mae provided liquidity for all our multifamily VRDOs in 2002 and has become our largest participant. We have asked Fannie Mae to consider providing liquidity to single family deals in 2003, and we currently plan to issue auction bonds for multifamily this year. We have also asked Freddie Mac to act as a liquidity provider in 2003 for our single family bonds.

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LIQUIDITY PROVIDERS

(\$ in millions)

<u>Financial Institution</u>	<u>\$ Amount of Bonds</u>	<u>Type of Bonds</u>
Fannie Mae	\$ 405.9	MF
Lloyds TSB	331.5	SF
CalSTRS	236.2	SF/MF
Commerzbank	229.3	SF
Dexia Credit Local	217.5	SF
Bank of Nova Scotia	207.0	SF
Westdeutsche Landesbank	182.6	SF/MF
Landesbank Hessen-Thuringen	181.9	MF
KBC	151.2	SF
Bayerische Landesbank	135.6	SF
Bank of New York	101.0	SF
Bank of America	77.5	SF
Morgan Guaranty	14.0	SF/MF
State Street	11.4	SF
Total	\$2,482.6	

After credit rating downgrades to Commerzbank, one of our biggest providers, our Commerzbank-backed bonds have had to be remarketed at higher rates than other bonds backed by higher-rated financial institutions. As a result, we plan to eliminate almost all of our investors' exposure to Commerzbank through a variety of means, including converting \$218 million of Commerzbank-backed taxable bonds to indexed mode (and selling them to the FHLB) and, for tax-exempt bonds, restructuring most of them as auction rate securities. A \$42.5 million tax-exempt series has already been converted to auction rate.

2015

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