CalHFA

# REPORTS

2000

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State of California

2002

# MEMORANDUM

**To:** Board of Directors **Date:** September 5, 2003

Ken Carlson, Director of Financing

**From:** **CALIFORNIA HOUSING FINANCE AGENCY**

**Subject:** PROPOSED BOND ISSUING PARTNERSHIP WITH THE SOUTHERN CALIFORNIA HOME FINANCING AUTHORITY

I am pleased to report that we are working to implement a joint home loan financing program with one of California's largest local agency issuers of single family mortgage revenue bonds – the Southern California Home Financing Authority ("SCHFA"). SCHFA is a joint powers authority comprised of the Counties of Orange and Los Angeles (excluding the City of Los Angeles, which operates its own homeownership programs). SCHFA was formed in 1988 and has operated a large and successful MRB program over the years.

SCHFA has requested this partnership because of the difficulties they are currently having in designing and operating a successful MRB program in today's financial markets and because they believe that jointly with CalHFA a more attractive program can be offered in L.A. and Orange counties than either organization could otherwise provide.

Without the kind of access we have to the variable rate bond market it is difficult for them (and for many state and local housing agencies across the nation) to be sufficiently rate-competitive with the conventional mortgage market and to deal with the high cost of negative carry while investing the proceeds of their fixed-rate bonds at today's low short-term rates as loans are originated.

As a result of these market conditions and the high rate of prepayments of outstanding loans, SCHFA now has substantial tax-exempt authority banked in drawdown bonds and additional authority, primarily from prepayments, to be added this fall.

A partnership between CalHFA and SCHFA will accomplish the following:

- Allow SCHFA's tax-exempt authority to be used well in advance of tax law deadlines.
- Stretch CalHFA's own tax-exempt authority.
- Provide a program which increases lending in these two populous counties and provides additional assistance to low-income borrowers.

Under the terms of the proposed partnership between SCHFA and CalHFA, we will provide the credit for SCHFA, making it possible for them to issue variable rate bonds. We will then utilize their bond proceeds to purchase new CalHFA loans for borrowers buying homes in SCHFA's jurisdiction.

2003

Long-time Board members may recall that in 1997 CalHFA helped another local agency issue some $22 million of mortgage revenue bonds using the same procedure. As a result, the legal "heavy lifting" for such partnerships has already been done. In addition, since then each annual CalHFA financing resolution has included delegated authority to the staff to enter into similar agreements; hence no Board action is required today to authorize the proposed partnership.

Under the currently proposed terms of the partnership, we will be raising our income limit in L.A. County, offering low-income borrowers a lower rate in both counties, and paying the costs of issuance of the bonds and an ongoing fee to SCHFA against the unpaid principal balance of loans made to moderate-income borrowers. SCHFA will forgo receiving any fee on loans to low-income borrowers. The SCHFA members will use the fee income from loans to moderate-income borrowers to support other programs,.

In respect to the program changes described above, our Homeownership staff believes that it will be necessary to offer the same terms to borrowers in Los Angeles County outside SCHFA's jurisdiction (i.e., for home sales within the L.A. City boundaries) in order to avoid administrative confusion. This will add slightly to our costs (because of lowering the mortgage rate for low-income borrowers) but help us increase our volume in the City, where we have historically not met our population-based volume goals.

Each month we currently purchase approximately $38 million of loans financing home sales within SCHFA's area and another $5 million within the L.A. City boundaries. However, as a result of the partnership, we would anticipate increased demand in the area because of the increased income limits and lower rates for low-income borrowers as well as joint marketing efforts. As a result we can expect to exceed our annual volume goals for L.A. and Orange counties and thus also our overall volume goals for Homeownership. We will be monitoring the presumed additional volume to determine its effect on our workload and staffing needs.

SCHFA has asked us to convert an initial $100 million of their tax-exempt authority for the proposed joint program. We are planning to help them issue new bonds before the end of the year, and we would then use the proceeds to purchase new loans over a several-month period. In addition, in order to maximize structural efficiency and leverage their authority, we may decide to add some taxable SCHFA bonds to the issue. If the current financial conditions continue, we would expect SCHFA to wish to continue our partnership and offer another sizable amount for similar issuance.

In addition, we have offered to help SCHFA issue $50 million of short-term bonds to preserve refunding authority related to a SCHFA bond redemption (from loan prepayments) scheduled for November 1. By lending our credit to these drawdown (or similar) bonds we can assure that investors can be found.

By partnering with SCHFA we can help make certain that their tax-exempt authority is effectively used and does not expire. The partnership can also be expected to be valuable financially to CalHFA because of residual income from the loans (even after deducting costs and fees) and because the use of their tax-exempt authority may enable us to postpone the use of a portion of our own such resources.

**State of California**

# MEMORANDUM

2004

**To** Board of Directors **Date:** September 3, 2003

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

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

On July 21st we obtained interest rate swaps for $150 million of tax-exempt variable rate bonds. The total bond issue, including $50 million of unswapped taxable variable rate bonds, is $200 million. All the bonds will be issued on September 11. The transaction proceeds will be used to fund approximately 1,200 new loans with rates expected to range from 4.25% to 5.25%.

The bonds have been structured in two series as shown on the table on page 2. The Series K Bonds are tax-exempt variable rate demand obligations with liquidity to be provided by two banks, Bank of Nova Scotia and State Street bank each with a 50% obligation. The Series L Bonds are taxable variable rate LIBOR-indexed bonds that will be insured by MBIA and are expected to be purchased by the Federal Home Loan Bank of San Francisco. If interest rates stay low we plan to leave these bonds outstanding and directly recycle prepayments into new mortgages.

In order to reduce the overall cost and eliminate negative carry during loan origination we were able to arrange for forward starting swaps that will start in August 1, 2004. The Series K bonds were sold in a stepped rate with a low fixed interest rate of 1.15% through August 1, 2004, when we plan to remarket the bonds in a weekly mode, coinciding with the start of the swaps. The swaps utilize the LIBOR index that affords us a greater interest rate savings at the risk of future tax law changes. The swaps are structured with declining notional amounts that match the expected amortization of the corresponding variable rate bonds. One of the swaps has call options built into the structure. These call options will allow the Agency to keep the swap and bond balances in sync when prepayments exceed forecasted levels.

2005

| SERIES | K | L |
|---|---|---|
| $ Amount | $150,000,000 | $50,000,000 |
| Type of Bonds | VRDO | Indexed Floaters |
| Tax Treatment | AMT | Taxable |
| Maturities | 2033 & 2034 | 2034 |
| Average Life | 2033: 9.7 yrs<br>2034: 20.3 yrs | 4.36 yrs. |
| Interest Rates | Variable | Variable |
| Reset Frequency | Fixed until 8/1/04 | Quarterly |
| Floating Rate Swap Formula | 60% of LIBOR + 26 bps | N/A |
| Swap Rates | 3.27 % & 4.247 % | N/A |
| Swap Start Date | 8/1/04 | N/A |
| Credit Rating | Aa3/AA-<br>VMIG-1/A-1 | Aaa/AAA |
| Bond Insurer | N/A | MBIA |

**State of California**

# MEMORANDUM

2006

**To** Board of Directors **Date:** September 4, 2003

Ken Carlson, Director of Financing

**From:** **CALIFORNIA HOUSING FINANCE AGENCY**

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

On July 31st we issued $313 million of taxable short-term LIBOR indexed bonds under the Home Mortgage Revenue Bond indenture. We issued this same type of bond in January of this year with the $295 million HMRB 2003 A transaction. The 2003 Series A and Series J Bonds have been:

- Issued to preserve tax-exempt authority resulting from bond principal retirements.
- Issued in variable rate form with a rate that is reset quarterly based on an index.
- Issued in taxable form to avoid arbitrage rebate requirements of federal tax law for tax-exempt investments[1].
- Insured by triple-A-rated bond insurance companies.
- Purchased by the Federal Home Loan Bank of San Francisco (FHLB).
- Issued with a two year maturity.

In addition, the proceeds from both series of bonds are invested in the State's Surplus Money Investment Fund, currently at a rate of about 1.60%. Investment of the proceeds of the Series A bonds has already provided approximately $150,000 of retainable earnings net of all related expenses. We expect our costs of issuance for the Series J transaction to be paid for in about 5 months, after which time any investment profits may be retained.

The initial rate for the Series J bonds was set at 1.21%. The Agency has the right to redeem the Series J bonds on February 1, 2004 and quarterly thereafter and the FHLB has the right to tender the bonds on August 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.

[1] Federal tax law requires that all profits on nonmortgage (nonpurpose) investments of tax-exempt housing bond proceeds be rebated to the federal government. Taxable bond proceeds are not subject to these rules.

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**State of California**

# MEMORANDUM

2008

**To:** Board of Directors

Date: September 4, 2003

Ken Carlson, Director of Financing

**From:** **CALIFORNIA HOUSING FINANCE AGENCY**

**Subject:** REPORT OF BOND SALE AND INTEREST RATE SWAP AGREEMENTS
MULTIFAMILY HOUSING REVENUE BONDS III, 2003 SERIES B

On August 20th we set swap rates for $34,805,000 out of $69,725,000 of multifamily variable rate bonds to be issued on September 10th. This is our second multifamily issue of 2003, and again we are issuing auction rate bonds. Both series of bonds are backed by our Aa3/AA- general obligation but are rated Aaa/AAA because of bond insurance provided by MBIA Insurance Corporation. Interest rates for the Series B bonds will reset quarterly.

The Series B bonds are being issued to provide funds to finance new loans to eleven multifamily projects and to refund an interim loan made by the Agency from a line of credit with Bank of America for a multifamily project initially funded by local agency bonds. Attached is a listing of the projects to be financed by the Series B bonds.

As shown in the table below, we have obtained three interest rate swaps, together in an amount related to the new permanent loans. Consistent with our strategy for previous multifamily transactions, amounts related to bridge loans, construction loans and lender loans are not being swapped due to the short term of these loans. As with previous transactions, we have chosen to delay the starting dates for the three swaps. Delayed starts enable us to minimize negative carry from our investments during the period between the issuance of the bonds and the date new loans are funded.

| Amount of Swap | Start Dates | End Dates | Interest Rates | Floating Rate Index |
|---|---|---|---|---|
| $9,415,000 | 12/1/2004 | 8/1/2038 | 3.883% | 60% of LIBOR + 0.26% |
| $15,845,000 | 07/1/2005 | 2/1/2036 | 3.968% | 60% of LIBOR + 0.26% |
| $9,545,000 | 02/1/2006 | 8/1/2038 | 4.06% | 60% of LIBOR + 0.26% |

Attachment

2009

**Attachment**

## New Loans

| Project Name | Loan Amount | Interest Rate | Actual/Projected Loan Origination Date |
|---|---|---|---|
| Baywood Apts. | $ 4,035,000 | 5.25% | 15-Sep-05 |
| Glenbrook Apts. | 5,690,000 | 5.45% | 01-Aug-04 |
| Kennedy Meadows Apts. | 4,890,000 | 5.25% | 30-Jul-04 |
| Mission Gateway | 18,515,000 | 5.25% | 01-Mar-05 |
| Moore Village at Wildhorse | 4,895,000 | 5.25% | 01-Oct-05 |
| Oak Court Apts. | 11,500,000 | 5.25% | 01-Jun-05 |
| Point Reyes Affordable Homes | 3,985,000 | 5.25% | 01-Oct-05 |
| Tremont Green | 3,625,000 | 5.25% | 01-Dec-04 |
| Union Court Family (*) | 1,295,000 | 5.75% | 19-Aug-03 |
| Villa Madera Apts. | 8,500,000 | 5.25% | 15-Mar-05 |
| West Covina Senior Villas | 2,800,000 | 5.25% | 01-Feb-04 |
| Total | $ 69,730,000 | | |

(*) This project was initially funded with local agency bonds.

State of California

2010

# MEMORANDUM

**To:** Board of Directors

**Date:** September 4, 2003

Ken Carlson, Director of Financing

**From:** **CALIFORNIA HOUSING FINANCE AGENCY**

**Subject:** UPDATE ON VARIABLE RATE BONDS AND INTEREST RATE SWAPS

The following report describes our variable rate bond and swap positions as of the September Board Meeting. In an effort to make the report more readable, I have revised its format, giving separate pages to each section.

The sections are as follows:

- Variable Rate Debt Exposure
- Interest Rate Swaps
- Basis Risk
- Risk of Changes to Tax Law
- Amortization Risk
- Termination Risk
- Types of Variable Rate Debt
- Liquidity Providers
- Bond and Swap Terminology (New section)

On July 31 Terri Parker and I visited the New York offices of both Moody's Investors Service and Standard & Poor's, the two nationally-recognized credit rating services that rate CalHFA's credit. With the help of our bankers and consultants we presented information showing that CalHFA's reliance on variable rate bonds and interest rate swaps has been a successful yet prudent strategy. Even under the rating agencies' "worst case" scenarios for future interest rates, our financing programs remain solvent.

## VARIABLE RATE DEBT EXPOSURE

The total amount of CalHFA variable rate debt (not including our warehouse lines) is now $5.2 billion, 67% of our $7.8 billion of total indebtedness. As shown in the table below, our "net" variable rate exposure is $806 million, 10.3% 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 Assets | Swapped to Fixed Rate | Not Swapped or Tied to Variable Rate Assets | Total Variable Rate Debt |
|---|---|---|---|---|
| Single Family | $782 | $3,001 | $659 | $4,442 |
| Multifamily | 10 | 599 | 147 | 756 |
| Total | $792 | $3,600 | $806 | $5,198 |

Our net exposure has slightly increased since one year ago when it was $666 million and 8.5% of our indebtedness. Two years ago it was $643 million and 8.3% of our indebtedness; three years ago it was $504 million and 7.2%.

As discussed in each previous report, our $806 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 much of our bond proceeds, have now fallen to 1.6%. In addition, the high incidence of single family loan prepayments since early in 2001 has caused our loan portfolio to begin to contract in spite of our $1.1 billion pace of 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 not much more than 1%.

The table below summarizes this risk position.

NET VARIABLE RATE DEBT
*($ in millions)*

| | Tax-Exempt | Taxable | Totals |
|---|---|---|---|
| Short average life | $139 | $393 | $532 |
| Long average life | 91 | 183 | 274 |
| TOTALS | $230 | $576 | $806 |

2012

## INTEREST RATE SWAPS

Currently, we have arranged a total of 80 swaps with nine different counterparties for a combined notional amount of $3.6 billion and expect to enter into another $100 million or so of swaps during September in connection with our next single family bond issue. 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)*

| | Tax-Exempt | Taxable | Totals |
|---|---|---|---|
| Single family | $1,634 | $1,367 | $3,001 |
| Multifamily | 599 | 0 | 599 |
| TOTALS | $2,233 | $1,367 | $3,600 |

The table below shows the diversification of our swaps among the nine 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 also that with our most recent swaps with Merrill Lynch we are benefiting from the credit of their triple-A structured subsidiary.

SWAP COUNTERPARTIES

| Swap Counterparty | Credit Ratings Moody's | S & P | Fitch | Notional Amounts Swapped *($ in millions)* | Number of Swaps |
|---|---|---|---|---|---|
| Merrill Lynch Capital Services Inc. | | | | | |
| Guaranteed by: | | | | | |
| Merrill Lynch & Co. | Aa3 | A+ | AA- | $ 888.0 | 18 |
| MLDP, AG | Aaa | AAA | AAA | 306.0 | 8 |
| Citigroup Financial Products Inc. | Aa1 | AA- | AA+ | 702.2 | 15 |
| Lehman Brothers Derivative Products Inc. | Aaa | AAA | NR | 617.2 | 18 |
| Bear Stearns Financial Products Inc. | Aaa | AAA | NR | 546.2 | 9 |
| Goldman Sachs Mitsui Marine Derivative Products, L.P. | Aaa | AA+ | NR | 169.3 | 4 |
| AIG Financial Products Corp. | Aaa | AAA | AAA | 150.0 | 2 |
| UBS AG (Union Bank of Switzerland AG) | Aa2 | AA+ | AAA | 96.2 | 2 |
| JPMorgan Chase Bank | Aa3 | AA- | AA- | 96.5 | 2 |
| Bank of America, N.A. | Aa1 | AA- | AA | 29.1 | 2 |
| | | | | $3,600.3 | 80 |

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.

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 August 1, 2003 semiannual debt service payment date we made a total of $57.6 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 our swap floating rates are based on indexes, which consist of market-wide averages, while our bond floating rates are specific to our individual bond issues.

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 been maintained. For example, during 2002 the average BMA/LIBOR ratio was 77%, and so far this year it has been averaging 81.0%. The BMA (Bond Market Association) index is the market benchmark index for tax-exempt variable rates.

It should be noted, however, that the BMA-LIBOR relationship has recently shown some signs of righting itself. For example, during the months of July and August, our weekly VRDOs traded at average levels between 68% and 74% of LIBOR, depending on which bank acted as remarketing agent. It is not clear whether this lower ratio will continue.

When the BMA/LIBOR ratio is very high 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, we and our advisors looked for a better formula than a flat 65% of LIBOR. After considerable study of California tax-exempt variable rate history, we 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. Since last December we have amassed approximately $692 million of new LIBOR-based swaps using this new formula.

While we have dealt with this problem for new swaps, we still have approximately $1 billion of older swaps for which we receive a flat percentage (64% or 65%) of LIBOR. For these older swaps we are considering two different proposals for increasing the amount we receive when interest rates are very low and the BMA/LIBOR ratio is very high. However, the right decision may be to leave these older swaps as is.

When interest rates are very low, mismatches consequently are not large in terms of interest rate or dollars. As an example, with LIBOR at 1.11%, our mismatch between 65% of LIBOR (0.72%) and the 2003 average BMA/LIBOR ratio times LIBOR (0.90%) is only 0.18%. Of course, on $1 billion of bonds this adds up. However, over the relatively short history of CalHFA's usage of interest rate swaps, the mismatch was in our favor in previous years. On a cumulative basis the total mismatch was less than $200,000 against us as of August 1, 2003.

2015

## RISK OF CHANGES TO TAX LAW

For an estimated $1.7 billion of the $2.2 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 bonds in comparison to taxable securities. In these cases, if a tax law change were to result in tax-exempt rates being more comparable to taxable rates, the swap provider's payment to us would be less than the rate we would be paying on our bonds, again resulting in our all-in rate being higher.

We bear this same risk for $404 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 $2.1 billion, 27% of our $7.8 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.

2016

**AMORTIZATION RISK**

Our bonds are generally paid down (redeemed or paid at maturity) as our loans are prepaid. Our interest rate swaps 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 generally have had 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 $2.69 billion of prepayments, including over $1.1 billion in just the last six months. Of this amount, approximately $400 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 $400 million less than the current "notional" amounts of the interest rate swaps. Fortunately, the recent rise in long-term interest rates should have a significant effect on the amount of prepayments to be received this fall. We are already seeing daily prepayment activity slowing 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 investing the excess prepayments with the banks that originally provided us, for each transaction, with fixed-rate "float" agreements at what seem like high rates today. Many of these agreements, however, were written to limit the amount of time that we could leave moneys on deposit; in these cases the investment of the excess is an interim step until we implement longer-term strategies.

We believe that the best long-term strategy will be 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. Now that we have followed the market and raised the interest rates for newly-reserved loans, we will soon be receiving loans for purchase with interest rates ranging from 5.25% to 6%. Our plan is to purchase the higher rate loans (5.75% and 6.0%) with excess prepayment moneys over the next several months. To the extent we recycle excess prepayments into new loans, we may reduce the size of new bond transactions.

2017

**TERMINATION RISK**

Termination Risk is the risk that, for some reason, our interest rate swaps must be terminated prior to their scheduled maturity. Our swaps have a market value from time to time that depends on then current interest rates. When current fixed rates are higher than the fixed rate of the swap, our swaps have a positive value to us (assuming, as is the case on all of our swaps, that we are the payer of the fixed swap rate), and termination would result in a payment from the provider of the swap (our swap "counterparty") to us. Conversely, when current fixed rates are lower than the fixed rate of the swap, our swaps have a negative value to us, and termination would result in a payment from us to our counterparty.

Our swap documents allow for a number of termination "events", i.e., circumstances under which our swaps may be terminated early, or (to use the industry phrase) "unwound". One circumstance that would cause termination would be a payment default on the part of either counterparty. Another circumstance would be a sharp drop in either counterparty's credit ratings and, with it, an inability (or failure) of the troubled counterparty to post sufficient collateral to offset its credit problem. It should be noted that, if termination is required under the swap documents, the market determines the amount of the termination payment and who owes it to whom. Depending on the market, it may be that the party who has caused the termination may be owed the termination payment.

As part of our strategy for protecting the Agency when we entered the swap market in late 1999, we determined to choose only highly-creditworthy counterparties and to negotiate "asymmetrical" credit requirements in all of our swaps. These asymmetrical provisions impose higher credit standards on our counterparties than on the Agency. For example, our counterparties may be required to collateralize their exposure to us when their credit ratings fall from double-A to the highest single-A category (A1/A+), whereas we need not collateralize until our ratings fall to the mid-single-A category (A2/A).

At least quarterly we monitor the termination value of our swap portfolio as it grows and as interest rates change. Over time, since we entered the swap market, interest rates largely fell, up until the last two months. Growth in the portfolio combined with this steady downward trend in interest rates made our swap portfolio have a large negative value (to us), as shown in the table on the next page. However, this negative value has been greatly reduced by the recent rise in rates.

Because termination is an unlikely event, the fact that our swap portfolio has a large negative value, while interesting, is not necessarily a matter of direct concern. We have no plans to terminate swaps early (except in cases where we negotiated "par" terminations when we entered into the swaps) and do not expect that credit events triggering termination will occur, either to us or to our counterparties.

The Government Accounting Standards Board does not require that our balance sheet be adjusted for the market value of our swaps, and up until this year did not require that this value be disclosed in the notes to our financial statements. However, we have reported the (negative) value of the portfolio each year in the "Financial Analysis" section of our Business Plan and in the "Statistical Supplement" to our Annual Report.

The table below shows the history of the fluctuating negative value of our swap portfolio over the last two years.

TERMINATION VALUE HISTORY

| Date | Termination Value ($ in millions) |
|---|---|
| 6/30/01 | ($81.6) |
| 9/30/01 | ($178.6) |
| 12/31/01 | ($133.4) |
| 3/31/02 | ($ 86.2) |
| 6/30/02 | ($200.8) |
| 9/30/02 | ($344.6) |
| 12/31/02 | ($345.2) |
| 3/31/03 | ($345.1) |
| 5/31/03 | ($450.4) |
| 6/30/03 | ($409.9) |
| 7/31/03 | ($208.4) |
| 8/31/03 | ($212.9) |

It should be noted that during this period, the notional amount of the swaps has been increasing to our current total of $3.6 billion, and when viewing the termination value, one should consider both the change in market conditions and the increasing notional amount.

## 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 Securities | Indexed Rate Bonds | Variable Rate Demand Obligations | Total Variable Rate Debt |
|---|---|---|---|---|
| Single Family | $161 | $2,125 | $2,156 | $4,442 |
| Multifamily | 134 | 0 | 622 | 756 |
| Total | $295 | $2,125 | $2,778 | $5,198 |

Since September of 2000 we have been able to sell $2.1 billion of taxable single family variable rate bonds to the Federal Home Loan Banks, and we expect to sell another $100 million to the San Francisco FHLB over the next few months. These bonds have all been designed as indexed-rate securities. In addition, our $160 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. Dexia Credit Local, a highly-rated Belgian bank, is now our largest provider of liquidity, and we expect them to provide liquidity for our next transaction as well.

This year we have begun financing our multifamily program with auction rate securities, for which no liquidity support is required. Use of auction rate securities for multifamily will enable us to target Fannie Mae's remaining liquidity capacity to our single family deals. In addition, we continue to expect Freddie Mac to be ready to offer us liquidity services for single family bonds to be issued later this year.

LIQUIDITY PROVIDERS
*($ in millions)*

| Financial Institution | $ Amount of Bonds | Type of Bonds |
|---|---|---|
| Dexia Credit Local | $507.3 | SF |
| Fannie Mae | 396.7 | MF |
| Lloyds TSB | 329.6 | SF |
| Bank of Nova Scotia | 281.5 | SF |
| Landesbank Hessen-Thuringen | 180.7 | MF |
| Commerzbank | 163.1 | SF |
| Westdeutsche Landesbank | 167.3 | SF/MF |
| CalSTRS | 155.9 | SF/MF |
| KBC | 148.3 | SF |
| Bayerische Landesbank | 131.2 | SF |
| Bank of New York | 100.4 | SF |
| Bank of America | 75.0 | SF |
| State Street Bank | 75.0 | SF |
| Morgan Guaranty | 66.1 | SF/MF |
| Total | $2,778.1 | |

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 are eliminating almost all of our investors' exposure to Commerzbank through a variety of means, including converting 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. So far we have converted $103 million of Commerzbank-banked VRDOs to different modes.

Unlike our interest rate swap agreements, our liquidity agreements do not run for the life of the related bonds. Instead, they are seldom offered for terms in excess of five years, and a portion of our agreements require annual renewal. We expect all renewals to take place as a matter of course; however, changes in credit ratings or pricing may result in substitutions of one bank for another from time to time. Alternatively, we may choose to switch some of our VRDOs to auction rate in order to free up liquidity capacity of some current providers.

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## BOND AND SWAP TERMINOLOGY

**REVENUE BOND (OR SPECIAL OBLIGATION BOND) (OR LIMITED OBLIGATION BOND)** -- A type of security which is evidence of a debt secured by revenues from certain assets (loans) pledged to the payment of the debt.

**GENERAL OBLIGATION BOND** -- A type of security which is evidence of a debt secured by all revenues and assets of an organization.

**INDENTURE** -- The legal instrument that describes the bonds and the pledge of assets and revenues to investors. The indenture often consists of a general indenture plus separate series indentures describing each issuance of bonds.

**OFFICIAL STATEMENT** -- The "prospectus" or disclosure document describing the bonds being offered to investors and the assets securing the bonds.

**SERIES OF BONDS** -- An issuance of bonds under a general indenture with similar characteristics, such as delivery date or tax treatment. Example: "Name of Bonds", 1993 Series A. Each series of Bonds has its own series indenture.

**MATURITY** -- Date on which the principal amount of a bond is scheduled to be repaid.

**REDEMPTION** -- Early repayment of the principal amount of the bond. Types of redemption: "special", "optional", and "sinking fund installment".

**SERIAL BOND** -- A bond with its entire principal amount due on a certain date, without scheduled sinking fund installment redemptions. Usually serial bonds are sold for any principal amounts to be repaid in early (10 or 15) years.

**TERM BOND** -- A bond with a stated maturity, but which may be subject to redemption from sinking fund installments. Usually of longer maturity than serial bonds.

**DATED DATE** -- Date from which first interest payment is calculated.

**PRICING DATE** -- Date on which issuer agrees (orally) to sell the bonds to the underwriters at certain rates and terms.

**SALE DATE** -- Date on which purchase contract is executed evidencing the oral agreement made on the pricing date.

**DELIVERY DATE, OR ISSUANCE DATE** -- Date that bonds are actually delivered to the underwriters in exchange for the bond proceeds.

**REFUNDING** -- Use of the proceeds of one bond issue to pay for the redemption or maturity of principal of another bond issue.

**VARIABLE RATE BOND** -- A bond with periodic resets in its interest rate. Opposite of fixed rate bond.

**INTEREST RATE SWAP** -- An exchange between two parties of interest rate exposures from floating to fixed rate or vice versa. A Floating-to-Fixed swap converts floating rate exposure to a fixed rate.

**NOTIONAL AMOUNT** -- The principal amount on which the exchanged swap interest payments are based.

**COUNTERPARTY** -- One of the participants in an interest rate swap.

**LIBOR** -- London Interbank Offered Rate. The interest rate highly rated international banks charge each other for borrowing U.S. dollars outside of the U.S. Taxable swaps often use LIBOR as a rate reference index. LIBOR swaps associated with tax-exempt bonds will use a percentage of LIBOR as a proxy for tax-exempt rates.

**BMA** -- Bond Market Association. A weekly index of short-term tax-exempt rates.

**MARK-TO-MARKET** -- Valuation of securities or swaps to reflect the market values as of a certain date. Represents liquidation or termination value.

**DELAYED START SWAP** -- A swap which delays the commencement of the exchange of interest rate payments until a later date.

**SWAP CALL OPTION** -- The right (but not the obligation) to terminate a predetermined amount of swap notional amount, occurring or starting at a specific future date.

**INTEREST RATE CAP** -- A financial instrument which pays the holder when market rates exceed the cap rate. The holder is paid the difference in rate between the cap rate and the market rate. Used to limit the interest rate exposure on variable rate debt.

**SYNTHETIC FIXED RATE DEBT** -- Converting variable rate debt into a fixed rate obligation through the use of floating–to-fixed interest rate swaps.

**SYNTHETIC FLOATING RATE DEBT** – Converting fixed rate debt into a floating rate obligation through the use of fixed-to-floating interest rate swaps.

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**State of California**

# MEMORANDUM

**To:** Board of Directors **Date:** September 4, 2003

Ken Carlson, Director of Financing

**From:** **CALIFORNIA HOUSING FINANCE AGENCY**

**Subject:** ANNUAL INVESTMENT REPORT

In 1995 the Board adopted an investment policy and asked for a periodic investment report. Attached for your information is an investment report as of June 30, 2003, the end date for the most recent fiscal year. This report shows that CalHFA moneys continue to be invested conservatively and in accordance with the Board-approved investment policy.

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# INVESTMENT REPORT

## SUMMARY

As of June 30, 2003, CalHFA had $9.8 billion of assets, of which $3.6 billion (37%) consisted of investments (not mortgages). $919 million of this $3.6 billion was used to pay bond debt service due on August 1. For the fiscal year, CalHFA total revenues were $653 million, of which $107 million (16%) was investment interest income.

The following table shows what types of investments we hold for different categories of funds. Note that (as for the previous fiscal years) investment agreements are our most prevalent type of investment and are used exclusively for our bond funds. As before, our next most prevalent investment is the State's investment pool. The balances in these two categories have increased over last year for a number of reasons. For investment agreements, balances have increased because of the higher incidence of prepayments. For the investment pool, balances are up primarily because of our investment of proceeds of bonds and notes issued to preserve tax-exempt authority for future use.

| | AMOUNT INVESTED *($ in millions)* | | |
|---|---|---|---|
| Investment Type | Bond Moneys | Non-Bond Moneys | Total |
| Investment agreements | $1,979.9 | $0.1 | $1,980.0 |
| State investment pool | 1,106.7 | 336.1 | 1,442.8 |
| Securities (fair market value) | 109.3 | 7.1 | 116.4 |
| Money market and Bank deposit | 38.8 | 1.4 | 40.2 |
| Totals | $3,234.7 | $344.7 | $3,579.4 |

## INVESTMENT AGREEMENTS

As stated in the Investment Policy, we normally invest bond moneys in investment agreements. Such agreements give us a high level of security of principal, a fixed rate of return to match the fixed cost of our debt, and complete liquidity so that we can use them like interest-bearing checking accounts and make deposits and withdrawals on short notice.

The following table shows the types of bond moneys that are deposited into investment agreements.

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INVESTMENT AGREEMENT BALANCES
*($ in millions)*

| | Bond Proceeds (For Loan Purchases) | Drawdown Bond Proceeds | Reserve Funds | Debt Service Funds | Totals |
|---|---|---|---|---|---|
| Single Family | $0 | $180.4 | $93.0 | $1,461.7 | $1,735.1 |
| Multifamily | 163.8 | 0 | 13.4 | 67.7 | 244.9 |
| Totals | $163.8 | $180.4 | $106.4 | $1,529.4 | $1,980.0 |

The first two attachments show information about our $1.98 billion of deposits with financial institutions providing us with investment agreements. Note the high credit ratings of the institutions. If these credit ratings were to fall below a threshold level, we have the right to request collateralization or return of principal.

**STATE INVESTMENT POOL**

As shown by the table on the previous page, we have $1.44 billion invested with the State Treasurer in the State investment pool, which, over time, has given us security, a fair return (1.697% during June), complete liquidity, and administrative simplicity.

As stated in the Investment Policy, we invest most non-bond moneys in the pool. We also invest a significant amount of bond moneys in the pool, including, most recently, Home Mortgage Revenue Bond and Drawdown Bond proceeds as well as the proceeds of some of our new multifamily bonds. In addition, Housing Assistance Payments moneys from HUD for the Section 8 projects, servicing impound account moneys and mortgage revenue for some of the older transactions are also invested in the pool.

**SECURITIES**

The third attachment displays information about the $116.4 million (fair market value) of securities we hold. This category includes $96.4 million of Fannie Mae and Ginnie Mae securities backed by loans originated for our single family and multifamily programs. Note that the market value of the securities is greater than the amortized value because of declines in interest rates since the securities were obtained.

The commercial paper was purchased by our outside trustee (U.S. Bank Trust, National Association) for investment of certain escrow and program account moneys.

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## MONEY MARKET AND BANK DEPOSITS

Our outside trustee sweeps overnight deposits into a treasury securities money market fund which was paying 0.84% as of June 30. The amount invested in the money market includes some bond program moneys which we expect to use to purchase loans or mortgage backed securities or to pay costs of issuance. In addition, this category includes loan servicing revenues held in bank deposit accounts.

# CALIFORNIA HOUSING FINANCE AGENCY

## FUNDS INVESTED IN INVESTMENT AGREEMENTS

## TOTALS BY FINANCIAL INSTITUTION RATINGS

| Moody's Ratings | Amount Invested 6/30/03 | Percentage of Total Invested |
|---|---|---|
| Aaa | $963,061,385 | 48.63% |
| Aa1 | 272,994,142 | 13.79% |
| Aa2 | 105,191 | 0.01% |
| Aa3 | 743,859,562 | 37.57% |
| Total | $1,980,020,280 | 100.00% |

| S & P Ratings | | |
|---|---|---|
| AAA | 963,061,385 | 48.64% |
| AA+ | 1,529,116 | 0.08% |
| AA | 268,347,959 | 13.55% |
| AA- | 740,714,859 | 37.41% |
| A+ | 6,366,961 | 0.32% |
| Total | $1,980,020,280 | 100.00% |

## SUMMARY OF CALIFORNIA HOUSING FINANCE AGENCY FUNDS DEPOSITED IN INVESTMENT AGREEMENTS - JUNE 30, 2003

| INVESTMENT AGREEMENT PROVIDER | MOODY'S RATING | STANDARD & POOR'S RATING | AMOUNT INVESTED |
|---|---|---|---|
| Societe General | Aa3 | AA- | $ 455,589,433 |
| Bayerische Landesbank | Aaa | AAA | 346,382,976 |
| American International Group Matched Funding Corp. (AIGMFC) | Aaa | AAA | 333,169,601 |
| Westdeutsche LB | Aa1 | AA | 267,071,849 |
| Aegon Institutional Markets | Aa3 | AA- | 236,984,677 |
| CDC Funding | Aaa | AAA | 131,677,268 |
| FGIC Cap. Market Services | Aaa | AAA | 73,512,174 |
| Trinity | Aaa | AAA | 38,185,640 |
| MBIA Inv. Management Corp. | Aaa | AAA | 37,453,658 |
| Monumental Life Co. | Aa3 | AA- | 26,737,739 |
| JPMorganChase 1 | Aa3 | AA- | 16,756,827 |
| Canadian Imperial Bank | Aa3 | A+ | 6,261,770 |
| Bank of America | Aa1 | AA- | 3,538,090 |
| Rabobank Int. | Aaa | AAA | 2,680,068 |
| Pacific Life Co. | Aa3 | AA+ | 1,529,116 |
| Citibank | Aa1 | AA | 1,276,110 |
| Citicorp | Aa1 | AA- | 1,108,093 |
| Bankamerica Corp. | Aa2 | A+ | 105,191 |
| Total Funds Invested in Investment Agreements | | | $ 1,980,020,280 |

1. TMG Financial Pruducts' assets were purchased by JPMorganChase.

## SUMMARY OF CalHFA INVESTMENTS IN SECURITIES AS OF JUNE 30, 2003

| TYPE OF INVESTMENT | PAR VALUE | BOOK VALUE | MARKET VALUE | WEIGHTED AVERAGE COUPON | WEIGHTED AVERAGE REMAINING MATURITY |
|---|---|---|---|---|---|
| GNMA SECURITIES | $ 58,597,583 | $ 58,597,583 | $ 63,034,249 | 6.09% | 28.76 Years |
| FNMA SECURITIES | 30,020,503 | 30,205,737 | 33,408,994 | 6.37% | 24.21 Years |
| COMMERCIAL PAPER | 6,576,500 | 6,576,500 | 6,554,960 | 2.83% | 0.27 Years |
| U.S. TREASURY BONDS | 9,690,000 | 9,539,128 | 10,936,682 | 9.17% | 7.90 Years |
| REFCORP BONDS | 904,000 | 1,022,355 | 1,341,626 | 8.63% | 17.55 Years |
| FHLMC SECURITIES | 780,000 | 792,285 | 1,100,775 | 8.25% | 12.92 Years |
| TOTALS | $106,568,586 | $106,733,589 | $116,377,286 | | |