

# Homeownership and Special Programs

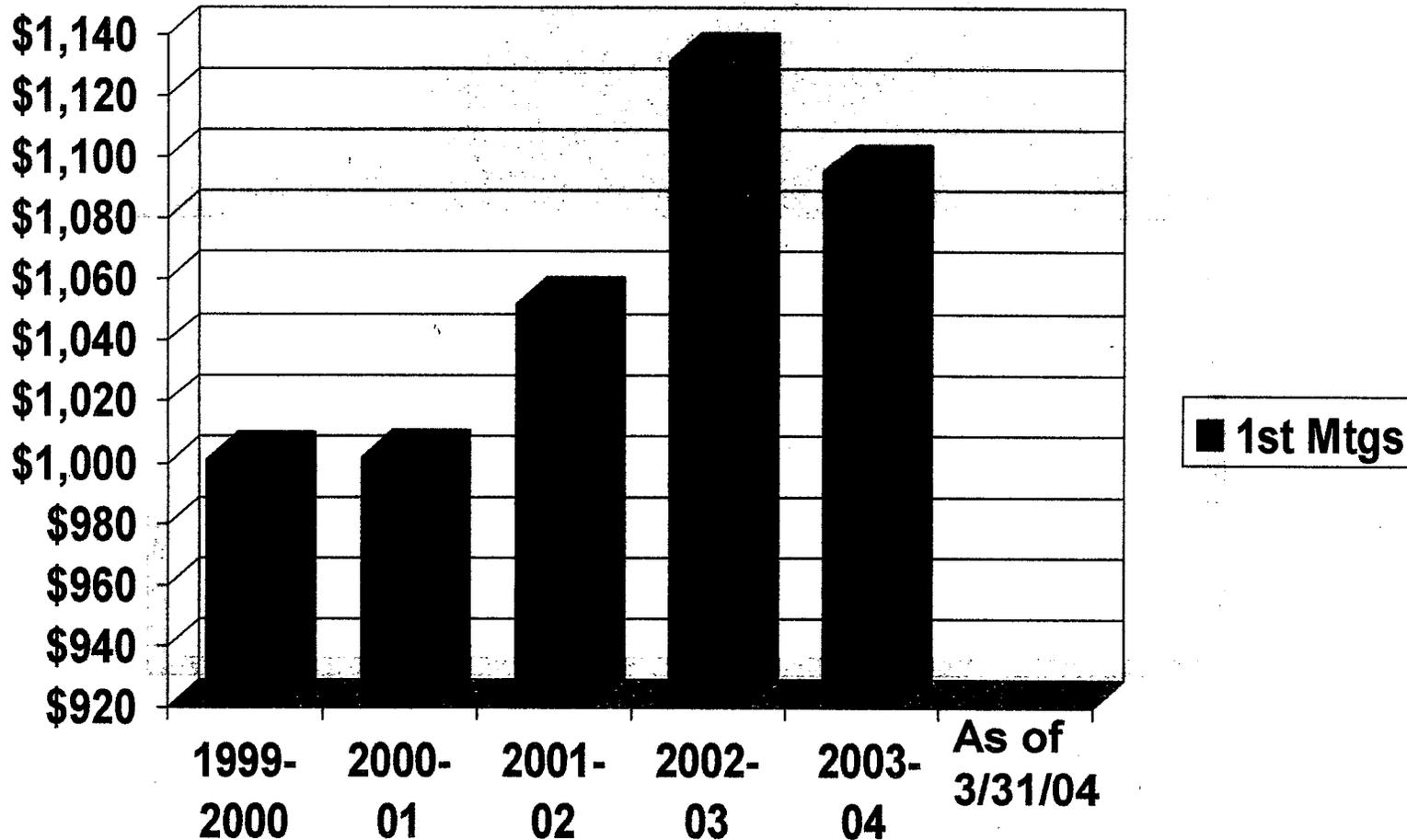
**Wayne Bell**

**Director of Homeownership Programs**



# Homeownership Purchases FY 1999-2000 to 3/31/2004

In millions

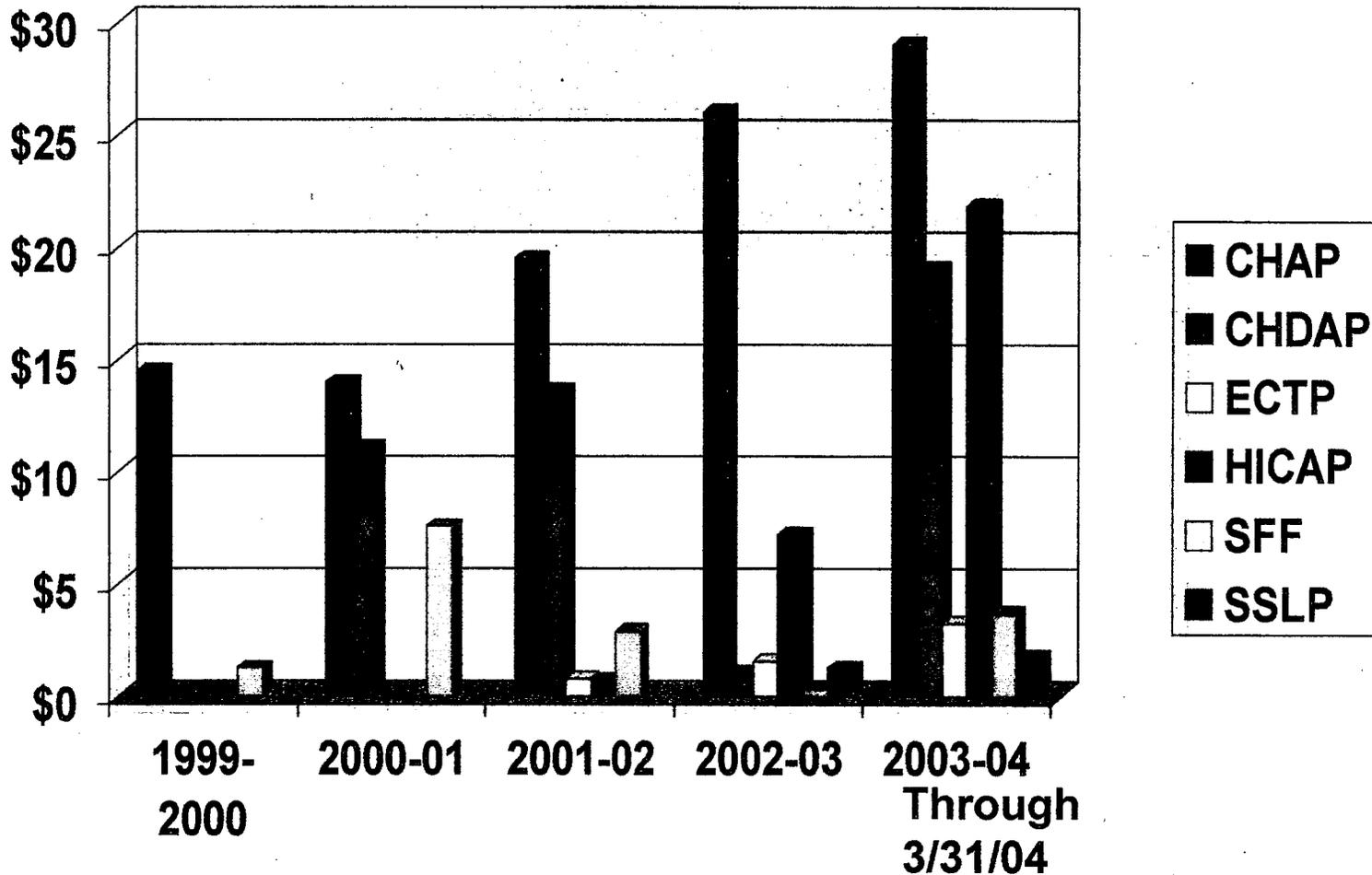


*Affordable Housing is our Business*



# Homeownership Special Programs Loan Purchases

In Millions



*Affordable Housing is our Business*



# Prop. 46 Downpayment Assistance Funds (in millions)

Program	Prop. 46 Funds	Start Date	Disbursed as of 4/30/04	Pipeline	Balance
CHDAP	\$111.60	1/29/2003	\$20.30	\$7.00	\$84.30
ECTP	\$23.75	7/1/2003	\$1.83	\$1.43	\$20.49
SFF	\$47.50	2/26/2003	\$3.70	\$0.57	\$43.23
HIRAP	\$11.90	2/26/003		\$0.12	\$12.48

CHDAP = California Homebuyer's Downpayment Assistance Program

ECTP = Extra Credit Teacher Program

SFF = School Facility Fee Down Payment Assistance Program

HIRAP = Homeownership In Revitalization Areas Program

*Affordable Housing is our Business*



# **Homeownership Objectives and Strategies**

- Providing long-term, fixed-rate first mortgages below conventional market interest rates
- Providing the lowest rates for low-income borrowers
- Supporting low income homeownership through the provision of layering down payment assistance and other incentives such as reduced interest rates
- Providing down payment assistance for teachers, administrators, other eligible staff and classified employees
- Implementing a 100% loan product and/or some other comparable products

*Affordable Housing is our Business*



# Homeownership Objectives and Strategies

- Providing outreach, technical assistance, and training support to lenders and other industry organizations
- Partnering with localities and nonprofit housing organizations to assist low-income borrowers
- Updating sales price limits consistent with federal law in order to assist the maximum number of first-time homebuyers
- Utilizing marketing and media resources to generate awareness for these programs and participating in special events



# Homeownership Programs Five Year Plan

Program	2003/04	2004/05	2005/06	2006/07	2007/08	5 Yr Totals
1 <sup>st</sup> Loans	\$1,250.0	\$1,300.0	\$1,350.0	\$1,400.0	\$1,450.0	\$6,750.0
SHBAP	2.5	2.5	2.5	2.5	2.5	12.5
CHAP	27.0	29.5	30.6	31.8	32.9	151.8
HICAP	32.5	34.1	35.8	37.6	39.5	179.5
Silent 2nds	3.0	3.0	3.0	3.0	3.0	15.0
Prop 46						
CHDAP	19.5	21.3	22.1	22.9	16.9	102.7
HIRAP	0.3					0.3
ECTP	6.6	6.6	6.6	0.2		20.0
SFF	7.4	7.7	8.1	8.5	8.7	40.4
Totals	\$1,348.8	\$1,404.7	\$1,458.7	\$1,506.5	\$1,553.5	\$7,272.2
In Millions						

*Affordable Housing is our Business*



# **Mortgage Insurance Services**

Nancy Abreu

Director Mortgage Insurance

May 12, 2004

*Affordable Housing is our Business*



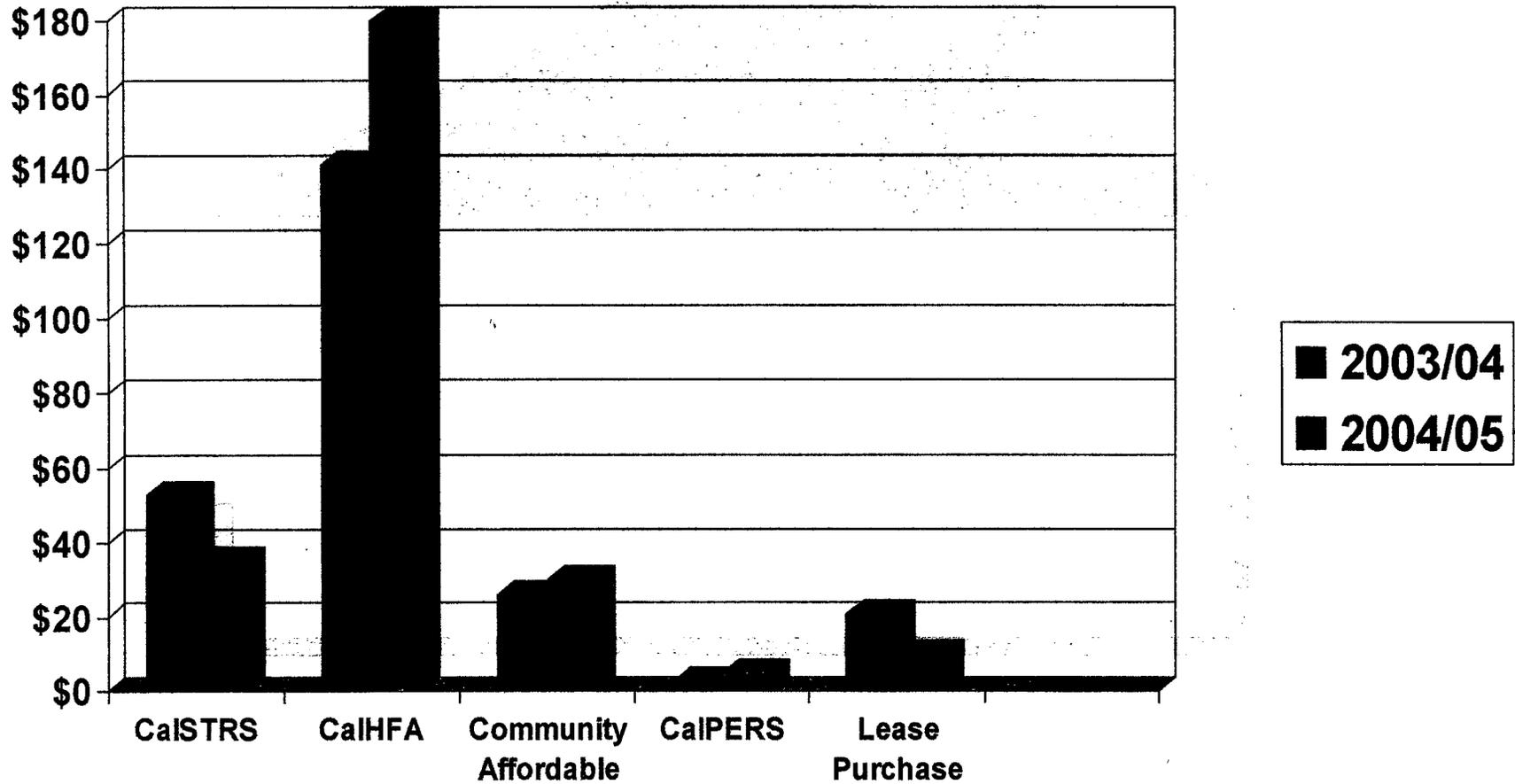
## **Accomplishments 2003 - 2004**

- Partnership with GEMICO
- GEMICO's technology
- Obtained legislative authority to adapt to changing market dynamics
- Expanded outreach activities
- New Program Development:
  - Developed New High Cost Area Program
  - Introduced Emerging Market Programs
  - Continuing development of programs and partnerships
  
- Updated Master Policy and Endorsements Issued
- Updated Product Description Published



*California Housing Finance Agency*

**Mortgage Insurance By Product  
(In Millions)**



*Affordable Housing is our Business*



## **2004 Strategies**

- Integrated Information Technology Vision and Platform
  - Electronic Data Exchange
  - Portfolio Data & Reports
  - CalHFA Portal
- Increase Production
  - Insuring Seconds
  - Expand Homeownership Programs
  - Expand Outreach
  - Expand Relationships



# **MULTIFAMILY PROGRAMS BUSINESS PLAN**

**FISCAL YEAR  
2004 - 2005**

**Linn Warren  
Director of Multifamily Programs**



## **Multifamily Programs Accomplishments Fiscal Year 2003 - 04**

- Projected to achieve 100% of the core lending goal with an estimated \$260 million in final commitments
- The HELP Program marked its sixth year with \$120 million in allocated commitments to 90 localities, representing 18,500 units
- Expected to close 35 projects with loans totaling \$233 million representing 2,818 units, the highest total for Multifamily
- Experienced strong growth in the construction lending program, currently 20 loans in process for \$262 million
- Significantly increased production capacity with 161 loans in process for \$734 million representing 91 projects

*Affordable Housing is our Business*



# Multifamily Programs Program Areas

- **New Construction**
  - Tax-Exempt debt with 4% credits as the primary structure
  - MHP utilized in numerous transactions
- **Preservation**
  - HUD 202 and 236 programs
  - Agency Section 8 portfolio re-financings
  - Prop 46 acquisition loans
- **Mixed Income**
  - 80/20 loans in redevelopment areas
  - HOPE VI and Student Housing



# Multifamily Programs Program Areas

- **Special Needs**
  - Coordination with service provider activities
  - Construction and bridge financing
  - Increased outreach to localities
- **Special Lending**
  - HELP
  - Tax Increment for small to medium RDA's
  - Small project infill and rehabilitation



•

•

# Multifamily Business Plan FY 2004 - 05 Production Goals (in millions)

Permanent Loans	\$160
Construction Lending	\$100
Preservation Acquisition	\$35
Prop 46 Opportunity Funds	\$15
HELP	\$20
Local Initiatives	\$10
Small Business	\$3
<b>Total Commitment Volume</b>	<b>\$343</b>

*Affordable Housing is our Business*



# **Multifamily Programs Initiatives**

- Refinancing non-profit owned portfolios
  - Expiring and early exit tax credit projects
  - Federally assisted developments
  - New loan products including variable rate debt
- Supportive and special needs housing
  - Better coordination with MHP funding and program criteria
  - Increased emphasis on construction lending and project based vouchers
- Homeownership development lending
  - Low cost construction loans to increase affordability
  - Mezzanine financing by the Agency
  - Linkage to the Agency's homeownership programs

*Affordable Housing is our Business*



# **Multifamily Programs Initiatives**

- **Refine the Construction Loan Program**
  - Additional staff for cost estimation and disbursement processing
- **Implement a fully integrated Loan Origination System**
  - Vendor links
  - Loan progress tracking
  - Streamlined closing and imaging
  - Integrated links to MF loan servicing
  - MISMO and XML compliant



# **Financing Reports**

- **Recent Bond Sales and Swaps**
  - **\$200 M Single Family Bonds**
- **Variable Rate Bonds and Swaps**



*Affordable Housing is our Business*



# Recent Bond Issues

<u>Date of Sale</u>	<u>Bond Series</u>	<u>\$ Amount</u>
4/23/04	Home Mortgage Revenue Bonds 2004 Series DEF	\$200,000,000



# **New Single Family Bonds**

- **\$200 M HMRB 2004 DEF**
- **Proceeds for purchase of 1,050 new loans**
- **75% tax-exempt**
  - **\$20.9 M fixed-rate serials**
  - **\$129.1 M VRDO; swapped**
- **25% taxable**
  - **Indexed-rate**
  - **Sold to San Francisco FHLB**
  - **Not swapped**



# **Variable Rate Bonds and Swaps**

- **74% of all CalHFA bonds now variable**
  - **All but \$1.2 B swapped to fixed rate or tied to variable rate assets**
- **Swap counterparties**
  - **High credit ratings**
  - **Diversification of exposure**
- **Other risks**
- **Types of variable rate bonds**



# Variable Rate Debt as of May 11, 2004

(\$ in Millions)

	<b><u>Tied Directly to Variable Rate Assets</u></b>	<b><u>Swapped to Fixed Rate</u></b>	<b><u>Not Swapped or Tied to Variable Rate Loans</u></b>	<b><u>Total Variable Rate Debt</u></b>
<b>Single Family</b>	<b>\$ 521</b>	<b>\$ 3,285</b>	<b>\$ 976</b>	<b>\$ 4,782</b>
<b>Multifamily</b>	<b><u>21</u></b>	<b><u>648</u></b>	<b><u>190</u></b>	<b><u>859</u></b>
<b>TOTALS</b>	<b>\$ 542</b>	<b>\$ 3,933</b>	<b>\$ 1,166</b>	<b>\$ 5,641</b>

*Affordable Housing is our Business*



# Net Variable Rate Debt

(\$ in Millions)

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
Short average life	\$104	\$765	\$869
Long average life	<u>120</u>	<u>177</u>	<u>297</u>
<b>TOTALS</b>	<b>\$224</b>	<b>\$942</b>	<b>\$1,166</b>

*Affordable Housing is our Business*



# Fixed Payer Interest Rate Swaps

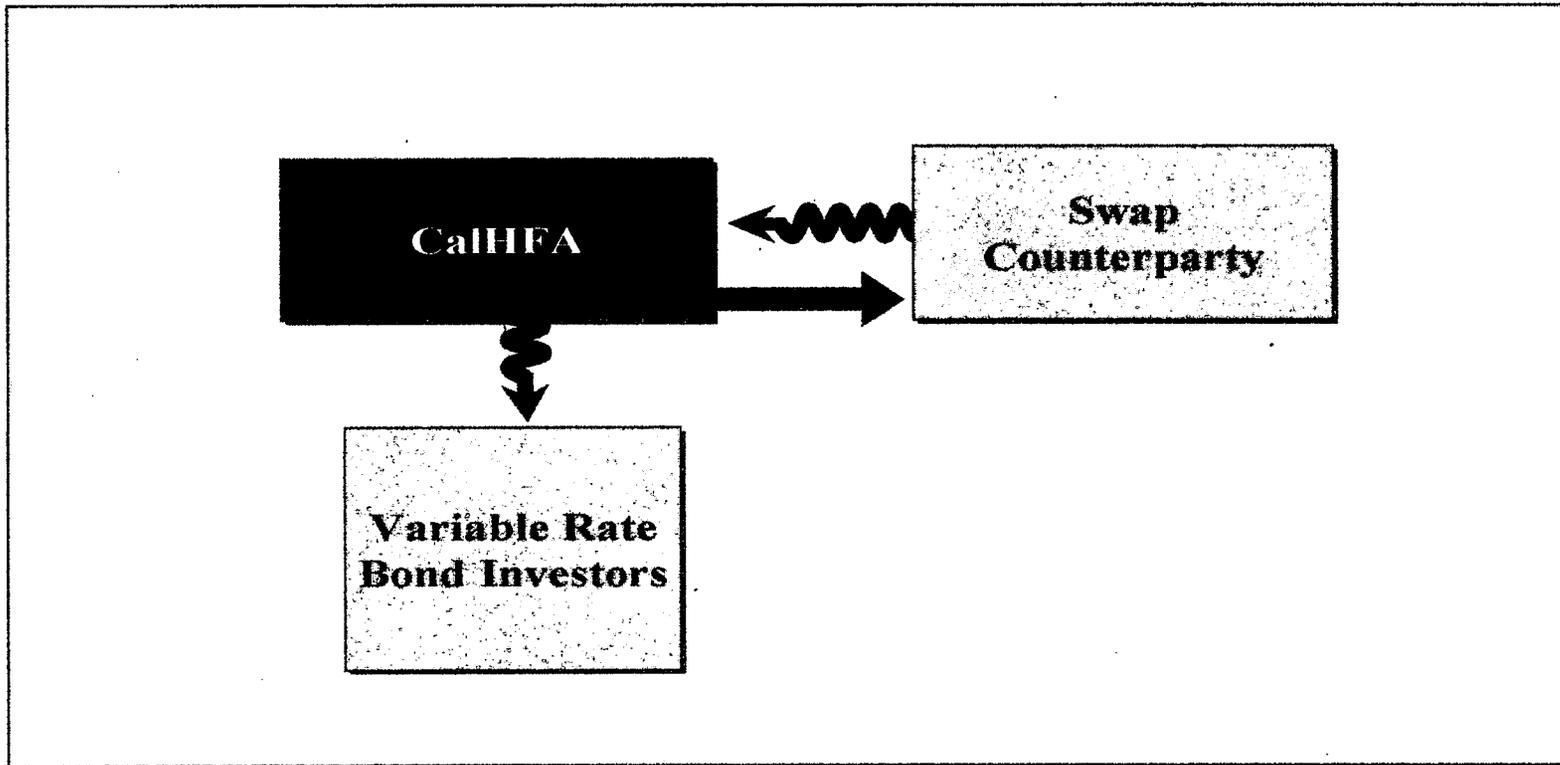
*(\$ in Millions)*

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
Single family	\$2,005	\$1,291	\$3,296
Multifamily	<u>756</u>	<u>0</u>	<u>756</u>
<b>TOTALS</b>	<b>\$2,761</b>	<b>\$1,291</b>	<b>\$4,052</b>

*Affordable Housing is our Business*



# Interest Rate Swap Diagram





# **Benefits of Swap Strategy**

- **Reduced cost of funds**
- **Reduced issuance costs**
- **Reduced cost of carrying debt before loan origination**
- **Ability to hedge future issues against higher rates**



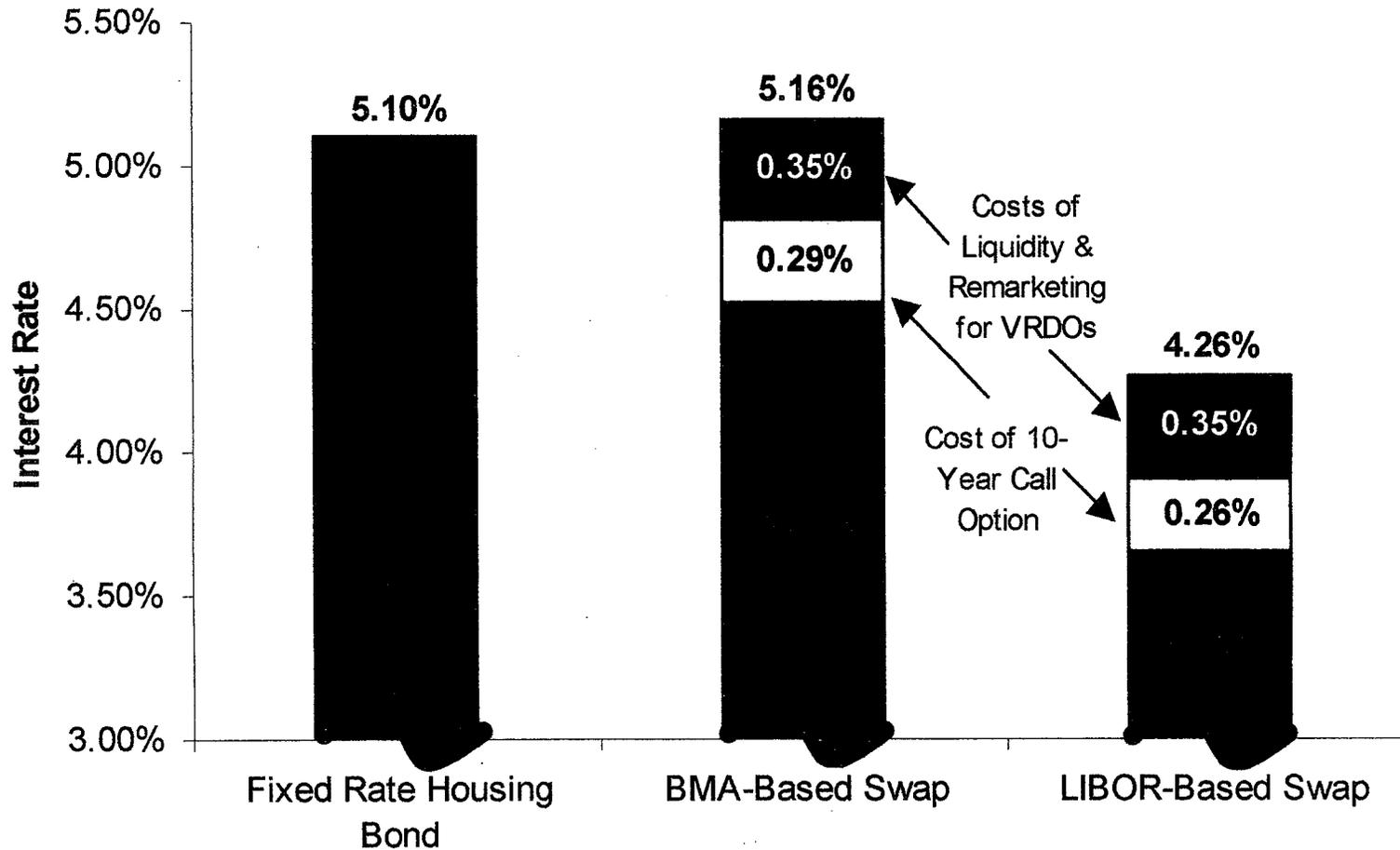
# **Risks of Swap Strategy**

- **Termination Risk**
- **Counterparty Risk**
- **Basis Risk**
- **Tax Law Change Risk**
- **Amortization Risk**
- **Liquidity Risk**



*California Housing Finance Agency*

**Comparative Costs of Funds for Fixed-Rate Bonds and Synthetic  
Fixed-Rate Bonds (Variable Rate Bonds Swapped to Fixed)  
(All Rates as of April 29, 2004)**



*Affordable Housing is our Business*



# Types of Variable Rate Debt

(\$ in Millions )

	<u>Auction Rate &amp; Similar Securities</u>	<u>Indexed Rate Bonds</u>	<u>Variable Rate Demand Obligations</u>	<u>Total Variable Rate Bonds</u>
Single Family	\$ 203	\$ 2,371	\$ 2,208	\$ 4,782
Multifamily	<u>231</u>	<u>21</u>	<u>607</u>	<u>859</u>
<b>TOTALS</b>	<b>\$ 434</b>	<b>\$ 2,392</b>	<b>\$ 2,815</b>	<b>\$ 5,641</b>

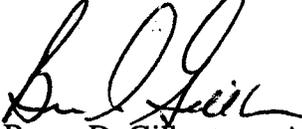
*Affordable Housing is our Business*



# MEMORANDUM

To: Board of Directors

Date: May 6, 2004



Bruce D. Gilbertson, Acting Director of Financing

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: UPDATE ON VARIABLE RATE BONDS AND INTEREST RATE SWAPS

Although we began issuing some variable rate bonds in 1995, it was not until 2000 that we began using variable rate debt as our primary issuance strategy with most of our interest rate exposure hedged in the swap market, as further described in this report. This strategy has enabled us to achieve a significantly lower cost of funds and a better match between assets and liabilities, all as described in detail in this report. These benefits are especially important in today's interest rate market, where short-term rates are extremely low and the usual rate advantage of tax-exempt financing is greatly reduced.

The following report describes our variable rate bond and swap positions. The report is divided into sections as follows:

- Variable Rate Debt Exposure
- Fixed-Payer Interest Rate Swaps
- Basis Risk and Basis Swaps
- Risk of Changes to Tax Law
- Amortization Risk
- Termination Risk
- Types of Variable Rate Debt
- Liquidity Providers
- Bond and Swap Terminology

**VARIABLE RATE DEBT EXPOSURE**

The total amount of CalHFA variable rate debt (not including our warehouse lines) is \$5.6 billion, 74% of our estimated \$7.6 billion of total indebtedness as of May 6, 2004. As shown in the table below, our "net" variable rate exposure is \$1.2 billion, 15% 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 ( <i>\$ in millions</i> )			
	Tied Directly to Variable Rate <u>Assets</u>	Swapped to Fixed Rate <u>Fixed Rate</u>	Not Swapped or Tied to Variable Rate <u>Assets</u>	Total Variable Rate Debt <u>Rate Debt</u>
Single Family	\$521	\$3,285	\$976	\$4,782
Multifamily	<u>21</u>	<u>648</u>	<u>190</u>	<u>859</u>
Total	\$542	\$3,933	\$1,166	\$5,641

Our net exposure has been adjusted to recognize that, of the \$682 million of proceeds of variable rate taxable notes currently outstanding, \$266 million is invested at a fixed rate. The remaining \$416 million of proceeds is invested at a floating rate. One year ago our net exposure was \$739 million and 9.5% of our indebtedness. Two years ago it was \$697 million and 8.9 % of our indebtedness; three years ago it was \$518 million and 7.0%.

As discussed in each previous report, our \$1.2 billion 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 1.41%. In addition, the high incidence of single family loan prepayments since early in 2001 has caused our loan portfolio to contract in spite of our \$1.3 billion pace of annual new single family and multifamily 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 have been running at just over one percent since the last time the Federal Reserve lowered overnight rates.

The table below summarizes this risk position.

	NET VARIABLE RATE DEBT ( <i>\$ in millions</i> )		
	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
Short average life	\$104	\$765	\$869
Long average life	<u>120</u>	<u>177</u>	<u>297</u>
TOTALS	\$224	\$942	\$1,166

**FIXED-PAYER INTEREST RATE SWAPS**

Currently, we have arranged a total of 95 “fixed-payer” swaps with nine different counterparties for a combined notional amount of \$4.05 billion. Included in this total is \$107 million of anticipatory swaps for multifamily bonds that are expected to be issued later this year and in 2005. All of these fixed-payer swaps are intended to establish synthetic fixed rate debt by converting our variable rate payment obligations to fixed rates. 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.

**FIXED PAYER INTEREST RATE SWAPS**

(notional amounts)

(\$ in millions)

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
Single family	\$2,005	\$1,291	\$3,296
Multifamily	<u>756</u>	<u>0</u>	<u>756</u>
<b>TOTALS</b>	<b>\$2,761</b>	<b>\$1,291</b>	<b>\$4,052</b>

The following table shows the diversification of our fixed payer 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

<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 &amp; P</u>	<u>Fitch</u>		
Merrill Lynch Capital Services Inc.					
Guaranteed by:					
Merrill Lynch & Co.	Aa3	A+	AA-	\$ 862.7	18
MLDP, AG	Aaa	AAA	AAA	303.6	8
Citigroup Financial Products Inc.	Aa1	AA-	AA+	813.0	17
Bear Stearns Financial Products Inc.	Aaa	AAA	NR	678.6	11
Lehman Brothers Derivative Products Inc.	Aaa	AAA	NR	599.4	18
AIG Financial Products Corp.	Aaa	AAA	AAA	260.1	8
Goldman Sachs Mitsui Marine Derivative Products, L.P.	Aaa	AA+	NR	167.1	4
JP Morgan Chase Bank	Aa3	AA-	AA-	146.2	5
Bank of America, N.A.	Aa1	AA-	AA+	129.0	4
UBS AG (Union Bank of Switzerland AG)	Aa2	AA+	AA+	<u>91.6</u>	<u>2</u>
				\$4,051.3	95

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.

For all of our fixed-payer swaps, 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 these swap agreements is from us to our counterparties. As an example, on our February 1, 2004 semiannual debt service payment date we made a total of \$61.6 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 AND BASIS SWAPS**

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. However, 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, the average BMA/LIBOR ratio was 77% in 2002, 84.3% in 2003, and the year-to-date for 2004 is 87.5%. The BMA (Bond Market Association) index is the market benchmark index for tax-exempt variable rates.

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 December of 2002 we have amassed approximately \$1.2 million of new LIBOR-based swaps using this new formula, and we expect to continue to use this formula for new swaps in 2004.

While we have dealt with this problem for new swaps, we still had approximately \$1 billion of older swaps for which we received a flat percentage (64% or 65%) of LIBOR. On February 1, we entered into basis swaps with two of our counterparties covering \$678 million of the older 65% of LIBOR swaps. Under the terms of these basis swaps, we have exchanged our 65% of LIBOR floating rate obligation for alternative formulas that provide us with better economics in low-rate environments. In one case, covering eight older swaps, our new payment obligation will be calculated based on a stepped-rate formula that provides a higher percentage of LIBOR in low-rate conditions. In the other case, for five older swaps, our new payment obligation will be a lower percentage of LIBOR plus a "spread". In both cases we expect to greatly alleviate the effects of the current high BMA/LIBOR ratio. Together these basis swaps are expected to save us almost \$2 million per year if short-term interest rates stay low.

## BASIS SWAP COUNTERPARTIES

<u>Swap Counterparts</u>	<u>Notional Amount Swapped (\$ in Millions)</u>	<u>Number of Swaps</u>
Bear Stearns Financial Products Inc.	\$328.7	8
Goldman Sachs Mitsui Marine Derivative Products, L.P.	349.5	5
Lehman Brothers Derivative Products Inc.	<u>12.9 *</u>	<u>1</u>
TOTALS	\$691.1	14

- \* This small swap executed in 2000 converted a portion of a LIBOR-based swap to a BMA basis, thus reducing tax risk.

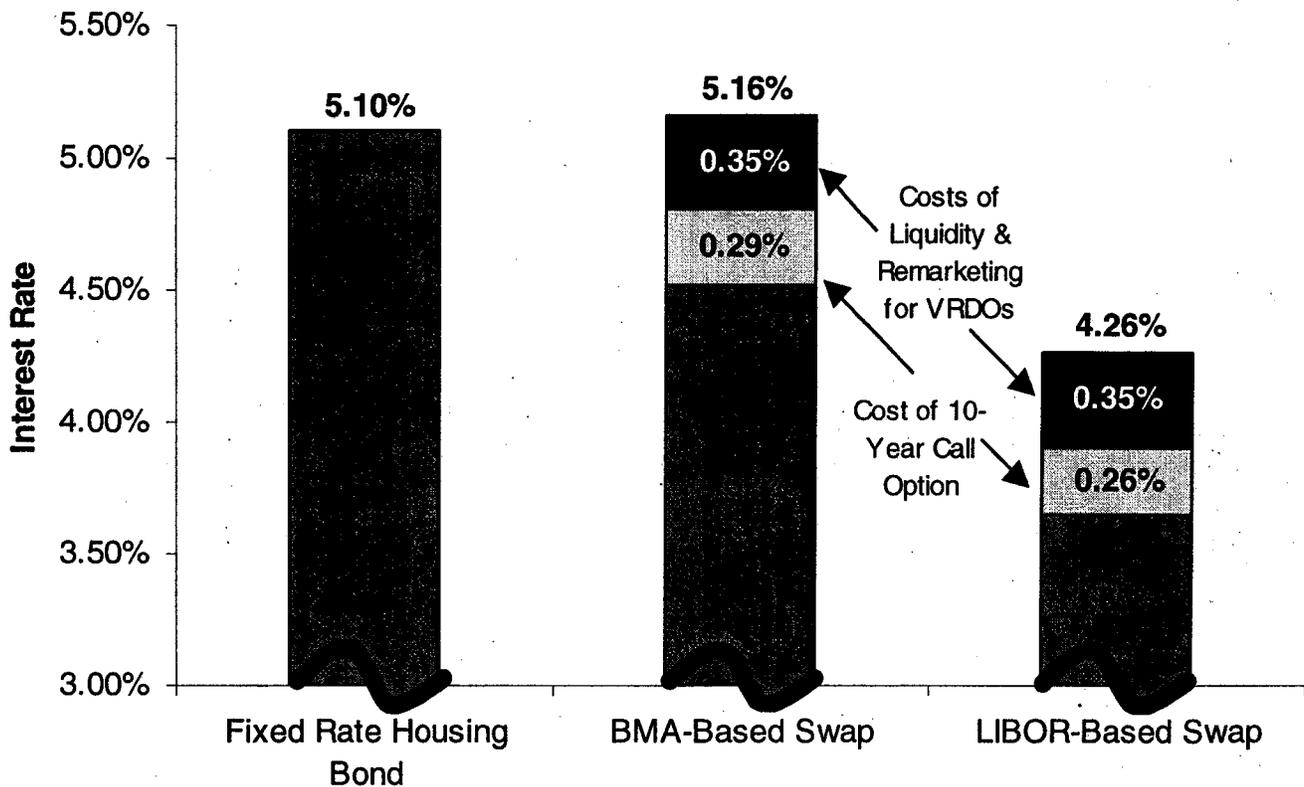
**RISK OF CHANGES TO TAX LAW**

For an estimated \$2.3 billion of the \$2.7 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 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 \$351 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 \$2.6 billion, 34.6% of our \$7.6 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.

The bar chart shows clearly that our ability to assume the risk of changes to tax laws is the "engine" that makes our interest rate swap strategy effective in today's market. If the Agency was unable or unwilling to take this risk, our cost of funds would be significantly higher. In fact, the chart shows that a BMA-based swap strategy, where we would avoid taking tax risk, would not produce an all-in cost of funds any different than that of a fixed-rate bond strategy.

Comparative Costs of Funds for Fixed-Rate Bonds and Synthetic Fixed-Rate Bonds (Variable Rate Bonds Swapped to Fixed)  
(All Rates as of April 29, 2004)



**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 over \$3.7 billion of prepayments, including over \$2.1 billion in 2003. Of this amount, approximately \$600 million is "excess" to swapped transactions we entered into between 2000 and 2002. In other words, our current loan portfolios for these 2000 through 2002 bond transactions have shrunk to amounts that are \$600 million less than the current "notional" amounts of the interest rate swaps.

Also of interest is our first instance (as of February 1, 2004) of a small \$11.8 million forced mismatch between the notional amount of certain of our swaps and the outstanding amount of the related bonds. These five small mismatches have occurred as a result of the interplay between our phenomenally high incidence of prepayments and the "10-year rule" of federal tax law. Under this rule, prepayments received 10 or more years beyond the date of the original issuance of bonds cannot be recycled into new loans and must be used to redeem bonds. In the case of these recent bond issues, a portion of the authority to issue them on a tax-exempt basis was related to older bonds.

While this small mismatch has occurred (and will show up in the tables of this report), the small semiannual cost of the mismatch will be more than offset by the large interest cost savings from our \$1.2 billion of "net" variable rate debt. In other words, while some of our bonds are "over-swapped", there are significantly more than enough unswapped variable rate bonds to compensate for the mismatch.

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 bulk of the excess prepayments with the financial institutions 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 recycle. With our May 1 transfer of loans from our warehouse line we will have recycled a total of \$437.4 million of excess prepayment moneys. Each month going forward we expect to continue high levels of recycling. This practice will likely result in reduced issuance activity in 2004.

### **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 that depends on 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 is 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, with a "bottom" in June of 2003. 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. This negative value was greatly reduced by the July rise in rates. However, falling rates this fall and winter caused the negative value to increase again, but not to the levels seen last May and June.

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, but, beginning last fiscal year, it does require that this value be disclosed in the notes to our financial statements.

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

#### TERMINATION VALUE HISTORY

<u>Date</u>	<u>Termination Value</u> <u>(\$ in millions)</u>
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)
9/30/03	(\$322.9)
10/31/03	(\$255.4)
11/30/03	(\$254.3)
12/31/03	(\$274.5)
1/31/04	(\$295.7)
2/29/04	(\$315.0)
3/31/04	(\$336.7)

It should be noted that during this period, the notional amount of our fixed-payer swaps has been increasing to our current total of \$4.1 billion. When viewing the termination value, one should consider both the change in market conditions and the increasing notional amount.

*\* As reported in our 2002/03 financial statements.*

**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 "puttable" bonds such as VRDOs.

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

	<u>Auction Rate &amp; Similar Securities</u>	<u>Indexed Rate Bonds</u>	<u>Variable Rate Demand Obligations</u>	<u>Total Variable Rate Debt</u>
Single Family	\$203	\$2,371	\$2,208	\$4,782
Multifamily	<u>231</u>	<u>21</u>	<u>607</u>	<u>859</u>
Total	\$434	\$2,392	\$2,815	\$5,641

Since September of 2000 we have been able to sell \$2.4 billion of taxable single family variable rate bonds to the Federal Home Loan Banks. In addition, our \$100 million of currently outstanding drawdown bonds are indexed-rate securities.

**LIQUIDITY PROVIDERS**

The table below 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/French bank, is the largest provider of liquidity, followed closely by Fannie Mae

In 2003 we began 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 single family deals. For instance, Fannie Mae recently provided liquidity for the first time to a single family bond issue that we did in partnership with the Southern California Home Financing Authority.

We are currently working toward obtaining liquidity for single family bond issues this year and next from eight different financial institutions. JPMorgan Chase Bank is providing us with additional liquidity for our current bond transaction, and we expect to obtain additional capacity from some of our other current providers (e.g. Fannie Mae and Bank of America) and hope to bring in as many as five new providers, including Freddie Mac.

Bank liquidity is more scarce today than in previous years for a couple of reasons. First, more and more issuers want to issue variable rate debt, and second, many banks apparently feel that, because of the State's budget crisis, this is not the time to increase exposure to California issuers.

LIQUIDITY PROVIDERS  
(*\$ in millions*)

<u>Financial Institution</u>	<u>\$ Amount of Bonds</u>	<u>Type of Bonds</u>
Dexia Credit Local	\$504.0	SF
Fannie Mae	484.1	SF/MF
Lloyds TSB	327.1	SF
Bank of Nova Scotia	278.7	SF
Bank of America	191.7	SF
JPMorgan Chase Bank	180.5	SF/MF
Landesbank Hessen-Thuringen	178.7	MF
KBC	143.1	SF
Westdeutsche Landesbank	142.2	SF
Bayerische Landesbank	120.7	SF
CalSTRS	89.6	SF/MF
Bank of New York	99.8	SF
State Street Bank	<u>75.0</u>	SF
Total	\$2,815.2	

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. In addition, we have begun to switch some of our VRDOs to auction rate in order to free up liquidity capacity of some current providers.

As a further matter, as of April of this year we have entirely eliminated our bondholders' exposure to Commerzbank, whose credit ratings were lowered in 2002. VRDOs backed by Commerzbank are being converted either to indexed rates (for purchase by the San Francisco FHLB) or to auction rates.

## 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 fixed-payer 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 fixed-payer interest rate swaps.

**SYNTHETIC FLOATING RATE DEBT**

Converting fixed rate debt into a floating rate obligation through the use of fixed-receiver interest rate swaps.

# MEMORANDUM

To: Board of Directors

Date: May 14, 2004

From: Tom Hughes, General Counsel  
**CALIFORNIA HOUSING FINANCE AGENCY**

Subject: May 12, 2004 Closed Session Board Meeting

California Government Code section 11126 requires that I submit to the Board a memo describing the legal basis for closed sessions held by the Board. The May 12, 2004 closed session meeting was held pursuant to Government Code section 11126 (e) (1), which provides that a closed session may be held to confer with counsel, or to receive advise from counsel, in connection with pending litigation, where to discuss such matters in open session might prejudice the position of the Agency in that litigation. The closed session was held to discuss the pending litigation in both WestLB AG v. California Housing Finance Agency, and CHFA v. Hanover California Accounting & Management Center Inc. It is my opinion that holding such discussions in open session would have prejudiced the position of the Agency in both matters.

