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2001

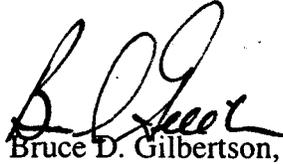
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2002

# MEMORANDUM

To: Board of Directors

Date: June 23, 2004



Bruce D. Gilbertson, Acting Director of Financing

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: REPORT OF BOND SALE AND INTEREST RATE SWAP AGREEMENTS  
SOUTHERN CALIFORNIA HOME FINANCING AUTHORITY  
SINGLE FAMILY MORTGAGE REVENUE BONDS 2004 SERIES B  
HOME MORTGAGE REVENUE BONDS 2004 SERIES GH

On June 3<sup>rd</sup>, we closed \$135,000,000 of bonds associated with the Agency's partnership with the Southern California Home Financing Authority (SCHFA). This is the second bond issuance under this program. The proceeds will be used to fund approximately 710 loans with rates expected to range from 4.50% to 5.25%.

As Board members may recall, SCHFA is a joint powers authority comprised of Los Angeles County and Orange County. Under the joint program, SCHFA is the issuer of \$100 million of tax-exempt bonds that are backed by CalHFA's Home Mortgage Revenue Bond program, and CalHFA holds SCHFA's bond proceeds separately. CalHFA's lenders will originate the joint program loans, and CalHFA will allocate them to the SCHFA bond issue. The Agency has blended \$35 million of its taxable bonds with the SCHFA bonds to provide a total of \$135 million of proceeds with this financing.

The bonds were structured in two series as shown on the table on page 2. The HMRB 2004 Series G Bonds are tax-exempt variable rate demand obligations with liquidity provided by BNP Paribas, a French owned bank. The Series H Bonds are taxable variable rate LIBOR-indexed bonds that are insured by FSA and were purchased by the Federal Home Loan Bank of San Francisco.

In order to reduce the overall cost and eliminate negative carry during loan origination we were able to arrange for swaps that will start in August, 2004 and February 2005. The Series B bonds were sold with a low fixed interest rate through the forward start dates of the swaps at which time we will remarket the bonds in a daily or weekly mode. 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 better allow the Agency to keep the swap and bond balances matched if sync when prepayments exceed forecasted levels.

2003

<b>SERIES</b>	<b>HMRB 2004 G</b>	<b>HMRB 2004 H</b>
\$ Amount	\$100,000,000	\$35,000,000
Type of Bonds	VRDO	Indexed Floaters
Tax Treatment	AMT	Taxable
Maturities	2034 & 2035	2034
Average Life	2034: 11.8 yrs 2035: 6.1 yrs	5.4 yrs.
Interest Rates	Variable	Variable
Reset Frequency	Fixed until 8/1/04 & 2/1/05	Quarterly
Floating Rate Swap Formula	60% of LIBOR + 26 bps.	N/A
Swap Rates	3.61 % & 4.0821%	N/A
Swap Start Date	8/1/04 & 2/1/05	N/A
Credit Rating	Aa2/AA-VMIG- 1/A-1+	Aaa/AAA
Swap Counterparty	BNP Paribas	N/A
Bond Insurer	N/A	FSA

The SCHFA's programs do not include properties within the City of Los Angeles; however the Agency plans to close a bond issue under a similar joint partnership with the City of LA in July 2004.

Because of the partnerships with SCHFA and the City of Los Angeles and our need to recycle excess loan prepayments related to various prior CalHFA bond issues, we have determined that we may not need to resume our normal financing schedule for some months.

2004

**M E M O R A N D U M****To:** Board of Directors**Date:** June 23, 2004

Bruce D. Gilbertson, Acting Director of Financing

**From:** CALIFORNIA HOUSING FINANCE AGENCY**Subject:** REPORT OF PARTNERSHIP WITH THE CITY OF LOS ANGELES  
HOME MORTGAGE REVENUE BONDS 2004 SERIES IJ

On June 4<sup>th</sup>, the Mayor of the City of Los Angeles approved a joint partnership with the Agency. This joint program with the City is similar to a program the Agency has created with the Southern California Home Financing Authority. Under the joint program, the City of LA is the issuer of \$30 million of tax-exempt bonds that are backed by CalHFA's Home Mortgage Revenue Bond program, and CalHFA holds the City of LA's bond proceeds separately. CalHFA's lenders will originate the joint program loans, and CalHFA will allocate them to the City's bond issue. The Agency has blended \$10 million of its taxable bonds with the City's bonds to provide a total of \$40 million of proceeds with this financing.

We expect to enter into a bond purchase agreement with Merrill Lynch on June 23<sup>rd</sup> and the bonds are expected to close on July 15<sup>th</sup>. The proceeds will be used to fund approximately 210 loans with rates expected to range from 4.50% to 5.25%.

The bonds will be structured in two series as shown on the table on page 2. The HMRB 2004 Series I Bonds will be sold as tax-exempt variable rate demand obligations with liquidity provided by State Street Bank. The HMRB Series J Bonds will be taxable variable rate LIBOR-indexed bonds that are insured by FSA and were purchased by the Federal Home Loan Bank of San Francisco.

To help reduce the overall cost and eliminate negative carry during loan origination we arranged for two forward starting swaps that will start in August, 2004. The Series I Bonds will be sold with a low fixed interest rate through August 4<sup>th</sup>, when we will remarket the bonds in a daily or weekly mode to coincide with the start date of the swaps. 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 that will better allow the Agency to keep the swap and bond balances matched if prepayments exceed forecasted levels.

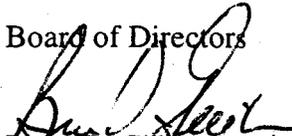
2005

<b>SERIES</b>	<b>HMRB 2004 I</b>	<b>HMRB 2004 J</b>
\$ Amount	\$30,000,000	\$10,000,000
Type of Bonds	VRDO	Indexed Floaters
Tax Treatment	AMT	Taxable
Maturities	2034 & 2035	2035
Average Life	2034: 13.3 yrs 2035: 5.3 yrs	3.28 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	3.56 % & 4.075 %	N/A
Swap Start Date	8/1/04	N/A
Credit Rating	Aa2/AA- VMIG-1/A-1+	Aaa/AAA
Swap Counterparty	Merrill Lynch	N/A
Bond Insurer	N/A	FSA

**MEMORANDUM**

To: Board of Directors

Date: June 23, 2004

  
 Bruce D. Gilbertson, Acting Director of Financing

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: REPORT OF BOND SALE AND INTEREST RATE SWAP AGREEMENTS  
 MULTIFAMILY HOUSING REVENUE BONDS III, 2004 SERIES AB

On March 12<sup>th</sup> we executed four anticipatory swaps for a total notional amount of \$50,120,000 (please see the Board report dated March 12, 2004 re Locking in Today's Low Rates for Future Multifamily Bond Issue) and on May 13<sup>th</sup> we executed two additional swaps for a total notional amount of \$19,950,000. In total, we set swap rates for \$70,070,000 of the \$123,010,000 of multifamily variable rate bonds to be issued on June 24<sup>th</sup>. The Series A and B bonds are being issued as variable rate securities that are remarketed weekly with interest paid semiannually. The Series A and B bonds are backed by our Aa3/AA- general obligation but are rated Aaa/AAA because of bond insurance provided by Financial Security Assurance, Inc.

The Series A and B bonds have been issued to provide funds to finance new loans to thirteen multifamily projects, to refund \$12,980,000 of prior CalHFA bond issues and to refund \$7,580,000 of local agency bonds. A total of seven prior loans will be transferred as a result of the refunding. Attached is a listing of the projects to be financed by the Series A and B bonds.

As shown in the table below, we have obtained six interest rate swaps, together in an amount related to the new and transferred 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 six swaps. Delayed starts enable us to minimize negative investment arbitrage during the period between the issuance of the bonds and the date new loans are funded or (in the case of the refunding component) the prior bonds are retired.

Amount of Swap	Start Dates	End Dates	Fixed Rates Paid to Counterparties	Floating Rate Index
\$23,900,000	8/1/2004	8/1/2034	3.059%	60% of LIBOR + 0.21%
\$7,590,000	8/1/2004	8/1/2034	3.386%	60% of LIBOR + 0.26%
\$5,680,000	8/1/2004	8/1/2034	3.330%	60% of LIBOR + 0.26%
\$12,950,000	8/1/2006	8/1/2036	3.692%	60% of LIBOR + 0.26%
\$3,060,000	8/1/2004	8/1/2034	4.539%	BMA - 0.15%
\$16,890,000	8/1/2006	2/1/2039	4.9783%	BMA - 0.15%

**Projects To Be Financed with The Proceeds of  
Multifamily Housing Revenue Bonds III 2004 Series AB**

2007

<u>Project Name</u>	<u>Loan Amount</u>	<u>Interest Rate</u>	<u>Actual/Projected Loan Origination Date</u>
<b>New Loans</b>			
Citrus Grove	\$3,790,000	5.50%	15-Jul-04
Coliseum Gardens	19,000,000	5.50%	01-Jan-06
Delaware Street	1,367,720	5.50%	06-Oct-03
Las Brisas	2,715,841	5.40%	(1) 27-Feb-04
Linden Manor	4,864,508	5.40%	(1) 27-Feb-04
Murphy Ranch II	7,235,000	5.50%	01-Apr-06
Newport Senior Apts.	8,570,000	5.40%	01-Jun-06
Oak Village Apts.	6,185,000	5.50%	01-Jun-04
Pacific Grove Senior	5,280,000	5.50%	01-Jul-06
Spring Village	11,915,000	5.50%	01-Apr-06
St. Vincent's Housing	17,000,000	5.50%	01-Jul-06
Via Del Mar	6,725,000	5.50%	01-Jan-06
Villa Amador	3,650,000	5.25%	01-Jul-06
Winters Apts.	1,354,413	5.40%	16-Dec-03
Woodglen Vista	10,381,458	5.90%	22-Jan-04
Total	<u>\$ 110,033,940</u>		

**Old Loans Transferred from Prior Bond Issue**

Crescent Terrace	\$1,321,751	8.50%	01-Aug-86
Dalton Arms	90,364	8.00%	27-Nov-84
Heritage Park	1,553,451	8.00%	01-May-85
Hidaway Apts.	3,213,801	7.50%	(2) 14-Aug-87
Huntcliffe	3,140,238	6.75%	(2) 29-May-87
Quail Terrace	3,810,217	8.30%	05-Apr-85
Willowbrook Green	2,187,201	4.00%	(2) 19-Nov-90
Total	<u>\$ 15,317,023</u>		

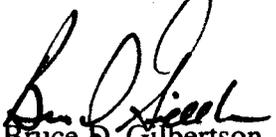
(1) These projects were initially funded by local agency bonds.

(2) Indicates current interest rates for existing stepped-rate loans (Hidaway Apts. (6.5% - 7.75%), Huntcliffe (5.75% - 7.75%) and Willowbrook Green (2% - 7.75%)). As a result of the refunding, the Agency staff intend to negotiate workout agreements with the borrowers to reduce or eliminate the stepped-rate feature of these loans.

**MEMORANDUM**

**To:** Board of Directors

**Date:** June 23, 2004

**From:**   
Bruce D. Gilbertson, Acting Director of Financing  
**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 \$5.9 billion, 75% of our \$7.9 billion of total indebtedness as of June 24, 2004. As shown in the table below, our "net" variable rate exposure is \$1.3 billion, 16% 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 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	\$3,414	\$1,021	\$4,956
Multifamily	<u>21</u>	<u>718</u>	<u>242</u>	<u>981</u>
Total	\$542	\$4,132	\$1,263	\$5,937

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 \$721 million and 9.4% of our indebtedness. Two years ago it was \$713 million and 8.8 % of our indebtedness; three years ago it was \$646 million and 8.4%.

As discussed in each previous report, our \$1.3 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 1.43%. 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 (\$ in millions)		
	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
Short average life	\$156	\$810	\$966
Long average life	<u>120</u>	<u>177</u>	<u>297</u>
TOTALS	\$276	\$987	\$1,263

**FIXED-PAYER INTEREST RATE SWAPS**

Currently, we have arranged a total of 101 "fixed-payer" swaps with ten different counterparties for a combined notional amount of \$4.2 billion. Included in this total is \$57 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	\$2,135	\$1,291	\$3,426
Multifamily	<u>775</u>	<u>0</u>	<u>775</u>
<b>TOTALS</b>	<b>\$2,910</b>	<b>\$1,291</b>	<b>\$4,201</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.

2011

## 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	353.5	12
Citigroup Financial Products Inc.	Aa1	AA-	AA+	813.0	17
Bear Stearns Financial Products Inc.	Aaa	AAA	NR	678.6	11
				328.7 *	8 *
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
				349.5 *	5 *
JP Morgan Chase Bank	Aa3	AA-	AA-	146.2	5
Bank of America, N.A.	Aa1	AA-	AA+	129.0	4
BNP Paribas	Aa2	AA-	AA	100.0	2
UBS AG (Union Bank of Switzerland AG)	Aa2	AA+	AA+	91.6	2
				\$4,201.2	101

\* Basis Swaps (not included in totals)

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 is currently at 89.05%. 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 \$1.3 billion of new LIBOR-based swaps using this new formula, and we expect to continue to use this formula. In addition, we entered into basis swaps for \$678 million of the older 65% of LIBOR swaps. The basis swaps provide us with better economics in low-rate environments by exchanging the 65% of LIBOR formula for alternative formulas that would alleviate the effects of the current high BMA/LIBOR ratio. The following table shows the diversification of variable rate formulas used for determining the payments received from our interest rate swap counterparties.

2013

**BASIS FOR VARIABLE RATE PAYMENTS  
RECEIVED FROM SWAP COUNTERPARTIES**  
(notional amounts)  
(\$ in millions)

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
60% of LIBOR + 26bps	\$1,337	\$0	\$1,337
3 mo. LIBOR + spread	0	794	794
BMA - 15bps	512	0	512
1 mo. LIBOR	0	415	415
Enhanced LIBOR <sup>1</sup>	349	0	349
Stepped % of LIBOR <sup>2</sup>	329	0	329
65% of LIBOR	318	0	318
6 mo. LIBOR	0	82	82
64% of LIBOR	41	0	41
60% of LIBOR + 21bps	<u>24</u>	<u>0</u>	<u>24</u>
<b>TOTALS</b>	<b>\$2,910</b>	<b>\$1,291</b>	<b>\$4,201</b>

<sup>1</sup> Enhanced LIBOR - This formula is 50.6% of LIBOR plus 0.494% with the proviso that the end result can never be lower than 61.5% of LIBOR nor greater than 100% of LIBOR.

<sup>2</sup> Stepped % of LIBOR - This formula has seven incremental steps where at the low end of the spectrum the swap counterparty would pay us 85% of LIBOR if rates should fall below 1.25% and at the high end, they would pay 60% of LIBOR if rates are greater than 6.75%.

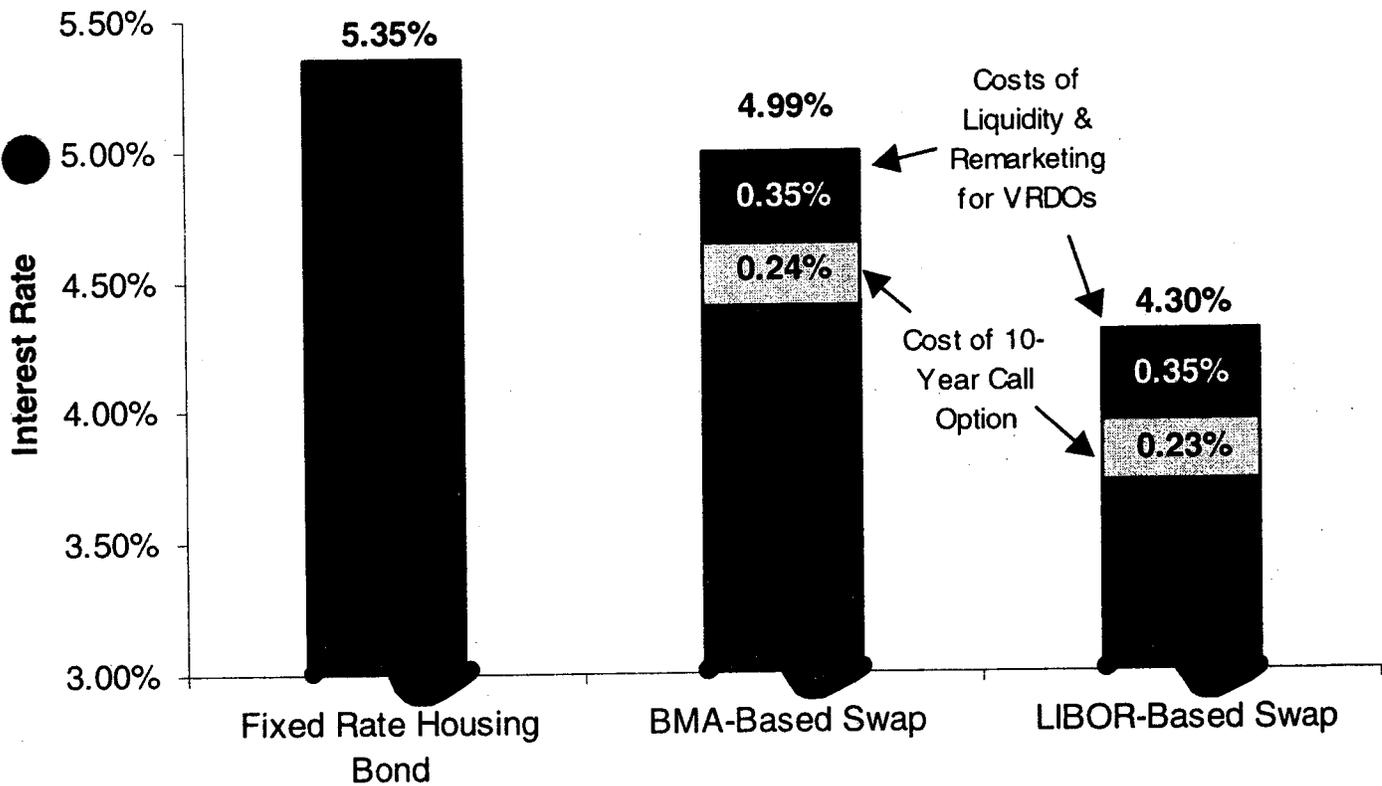
**RISK OF CHANGES TO TAX LAW**

For an estimated \$2.4 billion of the \$2.9 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 \$2.8 billion, 35.3% of our \$7.9 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 following 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.

**Costs of Funds for Fixed-Rate Bonds and Synthetic Fixed-Rate Bonds  
(Variable Rate Bonds Swapped to Fixed)  
(All Rates as of June 18, 2004)**



2015

**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 \$4 billion of prepayments, including over \$2.1 billion in 2003. Of this amount, approximately \$1.2 billion 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 \$1.2 billion 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 \$11.3 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 \$1.3 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 June 1 transfer of loans from our warehouse line we will have recycled a total of \$488.5 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 2003 rise in rates and recently has fallen to similar valuation levels.

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>
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)
4/30/04	(\$215.6)

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)*

	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	\$203	\$2,415	\$2,338	\$4,956
Multifamily	<u>353</u>	<u>21</u>	<u>607</u>	<u>981</u>
Total	\$556	\$2,436	\$2,945	\$5,937

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 different financial institutions. BNP Paribas, a new provider, recently provided us with \$100 million of liquidity for our latest single family financing. 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
State Street Bank	105.0	SF
BNP Paribas	100.0	SF
Bank of New York	99.8	SF
CalSTRS	89.6	SF/MF
Total	\$2,945.2	

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****2020****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.

**2021****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

2022

To: CalHFA Board of Directors

Date: 23 June 2004

From: Di Richardson, Director of Legislation  
CALIFORNIA HOUSING FINANCE AGENCY

Subject: Legislative Report

Lots of bills being heard this week, as the last day for policy committees to meet and pass or reject bills looms (June 25). Provided there is a Budget, the Legislature will break for recess July 2 – August 2. Below I have listed some of bills that are still alive and kicking (although some may be dead by the time you get this report). If you have any questions, please give me a call at (916) 324-0801 or email me at drichardson@calhfa.ca.gov.

**Building Standards**

**SB 1508 (Ducheny) Real property loans: restrictions (As Amended 6/22/04)**

**Status: ending Assembly Floor**

**Summary:** This bill would prohibit a person or entity from making a loan secured by a deed of trust or mortgage on non-owner-occupied residential real property if a notice of code violation has been recorded against the property by the local code enforcement agency, unless the loan does not exceed certain amounts, or unless a portion of the loan is withheld pending compliance with the code enforcement notice or to directly pay contractors for construction work completed in response to the code enforcement notice.

**SB 1634 (Alarcon) Real property: substandard conditions (As amended 6/15/04)**

**Status: Pending before Assembly H&CD Committee**

**Summary:** This bill would authorize the department charged with enforcing building standards or health department employee to issue an administrative citation for violations of those standards. The bill would require the building owner or owner's agent receiving an order or notice to abate to provide specified identification information to the city or county department that issued the order. The bill would authorize the department issuing the order or notice to provide specified notices in the event of noncompliance, after a reinspection. The bill would authorize the enforcement agency to charge the property owner for costs related to the issuance of the order or notice. The bill encourages each city or county department with enforcement of building standards to post a searchable database of violations on its website. In Senate Housing Committee, the bill was supported by a number of housing and labor organization. It was opposed by the California Apartment Association, California Housing Council, Apartment Association of Orange County, California Association of Realtors, Berkeley Property Owners Association, predominately because of the length of time information would be posted on the web.

**Construction Defect**

**AB 2333 (Dutra) Construction defect actions (As Amended 5/6/04)**

**Status: Pending before Senate Rules Committee**

**Summary:** This bill was originally introduced to promote the use of joint cost sharing agreements (JCSA) between builders and subcontractors. This issue continues to be the subject of negotiation. Pending the outcome of those discussions, the original content of the bill

was stripped, and placeholder language was added stating it is the intent of the Legislature to consider whether the existing process of resolution of residential construction defect claims could be revised for the mutual benefit of all interested parties.

**AB 2812 (Dutra) Prelitigation procedure: residential construction defects prior to 2003 (As Amended 5/12/04)**

**Status: Pending before Senate Rules Committee**

**Summary:** This bill was introduced to establish a prelitigation procedure required for residential construction pursuant to an agreement entered into prior to January 1, 2003, similar to the law that was passed (SB 800) for agreements after that date. This issue continues to be the subject of negotiation. Pending the outcome of those discussions, the original content of the bill was stripped, and placeholder language was added stating it is the intent of the Legislature to consider whether the existing process of resolution of residential construction defect claims could be revised for the mutual benefit of all interested parties.

**SB 1833 (Dunn) Construction defects: joint cost sharing agreements (As Introduced)**

**Status: Assembly. Read first time. Held at Desk.**

**Summary:** This bill was also introduced to establish a prelitigation procedure required for residential construction pursuant to an agreement entered into prior to January 1, 2003, similar to the law that was passed (SB 800) for agreements after that date. This issue continues to be the subject of negotiation. Pending the outcome of those discussions, the original content of the bill was stripped, and placeholder language was added stating it is the intent of the Legislature to consider whether the existing process of resolution of residential construction defect claims could be revised for the mutual benefit of all interested parties.

**Downpayment Assistance**

**AB 672 (Montanez) Housing: downpayment assistance and mortgages (As Amended 6/14/04)**

**Status: Senate Appropriations.**

**Summary:** This bill would increase the amount of downpayment assistance available to low- and moderate-income first-time homebuyers from the California Homebuyers Downpayment Assistance Program (funded by Proposition 46) that purchase newly constructed homes within a designated infill opportunity zone, transit development village, or transit-oriented specific plan area from 3% to 5%.

**AB 2838 (Salinas) Housing: downpayment assistance (As Amended 6/16/04)**

**Status: Senate Appropriations**

**Summary:** This bill would give CalHFA the authority to continue the Housing In Revitalization Area Program (HIRAP), which provides up to 6% downpayment assistance to low-income borrowers that complete an authorized homeownership counseling program beyond the current sunset date.

**Housing Element**

**AB 2158 (Lowenthal) Housing elements: regional housing need (As Amended 6/15/04)**

**Status: Senate Appropriations**

**Summary:** This bill reflects changes to the regional housing needs allocation process (RHNA) as proposed by the Housing Element Working Group. The bill would, among other things, provide greater transparency in how regional allocation numbers are developed and provides for greater local input.

**AB 2348 (Mullin) Housing elements: regional housing need (As Amended 6/14/04)**

**Status: Senate Appropriations**

**Summary:** This bill contains language developed by the Housing Element Working Group regarding adequate sites, land inventory and permitted use.

**Land Use**

**AB 1426 (Steinberg) Affordable housing: greater Sacramento region (As Amended 9/8/03)**

**Status: Senate Inactive File**

**Summary:** This bill, until January 1, 2011, would require, except as specified, every city and every county within the greater Sacramento region that issues building permits for residential units to require or otherwise cause at least 5% of the aggregate amount of these new residential units to be affordable to, and occupied by, very low income households, and at least 5% of the aggregate amount of these new residential units to be affordable to, and occupied by, low-income households, as specified. It would require each city and each county in the region to prepare and submit to the Secretary for Business, Transportation and Housing an annual report with specified information and would require the Secretary to, no later than June 30, 2010, submit a report to the Legislature regarding the number of affordable residential units in the region. By increasing the duties imposed on local officials, this bill would impose a state-mandated local program.

**SB 744 (Dunn) Planning: housing (As Amended 6/3/03)**

**Status: Pending before Assembly Local Government Committee**

**Summary:** This bill would require HCD to hear appeals from developers who have had an affordable housing development denied or have had conditions placed on the project that make it financially unfeasible. This bill is cosponsored by the CRLA and Western Center on Law and Poverty. It is opposed by the League of Cities, California State Association of Counties, California Chapter of the American Planning Association, Association of California Water Agencies, and several individual cities. It is currently not clear whether this bill will move in its present form. There is some discussion taking place regarding an alternative to create an arbitration process, but it not clear whether that language will move either.

**SB 1592 (Torlakson) Local planning (As Amended 6/09/04)**

**Status: Pending before Assembly Local Government Committee**

**Summary:** This bill would, except as specified, require each city and each county to adopt or update an infill ordinance or specific plan that identifies potential infill sites and specifies appropriate zoning to encourage infill development on vacant and underutilized parcels. It would require the infill ordinance to provide at least five incentives for infill housing, as specified, as well as an affordable housing strategy. In the Senate Local Government Committee, this bill was supported by the California Chapter of the American Planning Association, American Federation of State, County and Municipal Employees, and the East Bay Municipal Utility District. It was opposed by the League of California Cities.

**Landlord Tenant**

**SB 1328 (Torlakson) Housing: tenants: notices (As Amended 6/10/04)**

**Status: Pending in Senate for Concurrence**

**Summary:** This bill would expand the list of subsidies that require property owners to notify tenants when affordability restrictions will be terminated; would expand the required content of that notice; and would clarify that organizations obligated to maintain the affordability of the project have an opportunity to purchase such a project before it is offered to other buyers.

## Misc

### **SB 1404 (Soto) Multifamily improvement districts (As Amended 5/18/04)**

**Status: Pending before Assembly on Local Government**

**Summary:** This bill would provide for a program for the establishment of multifamily improvement districts to levy assessments on residential rental properties within the district to finance improvements and promote activities beneficial to those (residential) properties.

## Prevailing Wage

### **SB 730 (Burton) Prevailing rate of per diem wages: determinations (As Amended 9/4/03)**

**Status: Senate Inactive File**

**Summary:** This bill would require the Director of Department of Industrial Relations to provide these wage rates to an awarding body within 120 days of a request for the rates, and would require that any appeal of a wage rate determination be decided within 30 days of the appeal. This bill would also require the director to maintain a log, as a public record, of these determination requests and appeals, as provided.