





# REPORTS

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State of California

## MEMORANDUM

To: Board of Directors

Date: December 27, 2004



From: Bruce D. Gilbertson, Director of Financing  
CALIFORNIA HOUSING FINANCE AGENCY

Subject: Habitat for Humanity Investment

Since 1977, Habitat for Humanity International ("Habitat") has been raising money via annual note issuances, secured by existing mortgages on homes previously built by Habitat for Humanity affiliates ("Habitat Affiliates"). On December 21, 2004, we purchased \$262,000 of such notes. You may recall that in December 2003, for the first time, we purchased a similar \$490,000 note. The par amount of our investment corresponds to the total amount of funding requested by Habitat's California affiliates. Investing in these notes provides us with a convenient opportunity to support Habitat's programs in California without having to work with each affiliate separately. We look forward to continuing to support Habitat's programs in California by annually investing in future note issuances.

The attached press release describes more of the benefits achieved by our investment.

Attachment

**IMMEDIATE RELEASE**

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## **CALHFA AND HABITAT FOR HUMANITY CONTINUE PARTNERSHIP**

**SACRAMENTO, December 29, 2004** – Habitat for Humanity® and the California Housing Finance Agency (CalHFA) are teaming up again to provide new housing opportunities for California families in need.

This partnership enables California Habitat for Humanity affiliates to stretch their existing resources, generate more funds, and build more affordable homes that are urgently needed in our state. During December 2003, CalHFA purchased \$490,000 of mortgage-backed securities issued by Habitat for Humanity. In this second venture, CalHFA has invested another \$262,000 in this vital cause.

CalHFA's latest investment of over a quarter-million dollars will help provide funding to two Habitat for Humanity affiliates in California, including Habitat for Humanity San Joaquin County and Habitat for Humanity South Bay/Long Beach. These affiliates benefit by having immediate access to money they normally would collect over the life of the mortgages.

"CalHFA is constantly looking for innovative ways to help families who need an affordable place to live on terms they can manage," according to CalHFA's Executive Director, Theresa Parker. "We're pleased to continue to partner on this effort with the global, grass-roots organization Habitat for Humanity."

Habitat for Humanity is dedicated to eliminating poverty housing. Founded in 1976 by Millard Fuller, along with his wife, Linda, Habitat for Humanity International and its affiliates in more

- more -

than 3,000 communities in 92 nations have built more than 150,000 homes to provide families with no-profit, zero-interest mortgages. For more information, visit [www.habitat.org](http://www.habitat.org).

CalHFA, the state's affordable housing bank, was chartered in 1975 to meet the housing needs of low to moderate income Californians and has helped more than 130,000 families purchase their first home. More information on CalHFA programs is available at 1.800.789.2432 or [www.calhfa.ca.gov](http://www.calhfa.ca.gov).

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**M E M O R A N D U M****To:** Board of Directors**Date:** December 27, 2004**From:** Bruce D. Gilbertson, Director of Financing  
**CALIFORNIA HOUSING FINANCE AGENCY****Subject:** SUMMARY OF CALENDAR YEAR 2004 BOND FINANCINGS

Attached are tables and pie charts summarizing calendar year 2004 bond transactions and showing bonds issued over the last five years. During 2004 we issued bonds totaling \$2.13 billion, just shy of last years record issuance volume of \$2.15 billion. The majority of the 2004 volume (61%) is related to the \$1.3 billion of bonds and notes that were issued to preserve tax-exempt authority, including both new authority from CDLAC and "grandfathered" authority related to bond redemptions from prepayments.

Total Agency indebtedness (bonds and notes) as of December 31, 2004 is \$8.006 billion, a slight increase from \$7.996 billion as of the end of 2003. In addition, approximately \$1.2 billion of bond principal will be retired on February 1, 2005.

As shown in the table and accompanying pie charts, of the \$2.13 billion of bonds and notes issued during 2004 all but \$21 million were issued with variable interest rates. During the year, \$543.8 million of these variable rate bonds were swapped to fixed rates.

**SINGLE FAMILY FINANCINGS**

During calendar year 2004 we issued \$1.8 billion of bonds and notes for our homeownership loan programs, 86% of the year's issuance activity. Of the \$1.8 billion issued only \$560 million was issued as permanent debt to purchase loans. By comparison, during calendar year 2003 we issued \$955 million in permanent debt for our single family programs. The dramatic drop off in bond issuance activity is directly related to our increased recycling of prepayments from loans, originally financed by bonds issued in prior years, into new loans. During calendar year 2004, \$609 million of loan prepayments were used to finance new loans while in calendar year 2003 only \$178 million of loan prepayments were used to originate new loans.

In November 2004, we issued bonds under the Housing Program Bonds indenture for the first time. The \$50 million financing provided permanent funding for loans originated under two of the Agency's down payment assistance programs, CHAP and HiCap.

### MULTIFAMILY FINANCINGS

During calendar year 2004 we issued \$297 million of bonds to finance multifamily loans. By comparison, \$231 million of bonds were issued during calendar year 2003 for Agency rental housing programs.

### Attachments

CALIFORNIA HOUSING FINANCE AGENCY  
 FIVE-YEAR SUMMARY  
 BOND ISSUES FROM 2000 TO 2004

YEAR	PROGRAM	PRIVATE ACTIVITY BOND ALLOCATION RECEIVED	BONDS SOLD		END OF YEAR BONDS OUTSTANDING
			TAX-EXEMPT	TAXABLE	
2000	Single Family	\$217,128,000	\$824,647,265	\$673,800,000	\$1,498,447,265
	Multifamily	\$159,315,000	\$183,020,000	\$269,038,416	\$452,058,416
	SUBTOTAL	\$376,443,000	\$1,007,667,265	\$942,838,416	\$1,950,505,681
2001	Single Family	\$369,775,798 <sup>(1)</sup>	\$768,279,441	\$633,745,000	\$1,402,024,441
	Multifamily	\$123,550,000	\$204,230,000	\$39,185,000	\$243,415,000
	SUBTOTAL	\$493,325,798	\$972,509,441	\$672,930,000	\$1,645,439,441
2002	Single Family	\$500,655,188 <sup>(2)</sup>	\$1,485,434,138	\$418,000,000	\$1,903,434,138
	Multifamily	\$119,445,000	\$205,890,000	\$0	\$205,890,000
	SUBTOTAL	\$620,100,188	\$1,691,324,138	\$418,000,000	\$2,109,324,138
2003	Single Family	\$416,332,732 <sup>(3)</sup>	\$1,073,750,000	\$846,995,000	\$1,920,745,000
	Multifamily	\$227,370,000	\$231,035,000	\$0	\$231,035,000
	SUBTOTAL	\$643,702,732	\$1,304,785,000	\$846,995,000	\$2,151,780,000
2004	Single Family	\$693,000,000 <sup>(4)</sup>	\$1,389,370,000	\$396,305,000	\$1,785,675,000
	Single Family-DPA	\$0	\$50,000,000	\$0	\$50,000,000
	Multifamily	\$214,187,800	\$296,980,000	\$0	\$296,980,000
	SUBTOTAL	\$907,187,800	\$1,736,350,000	\$396,305,000	\$2,132,655,000
	5-YEAR TOTALS	\$3,040,759,518	\$6,712,635,843	\$3,277,068,416	\$9,989,704,259

<sup>(1)</sup> Includes \$73,775,798 of carryforward.

<sup>(2)</sup> Includes \$139,755,188 of carryforward.

<sup>(3)</sup> Includes \$86,460,327 of carryforward.

<sup>(4)</sup> Includes a approximate amount of \$305,000,000 carryforward.

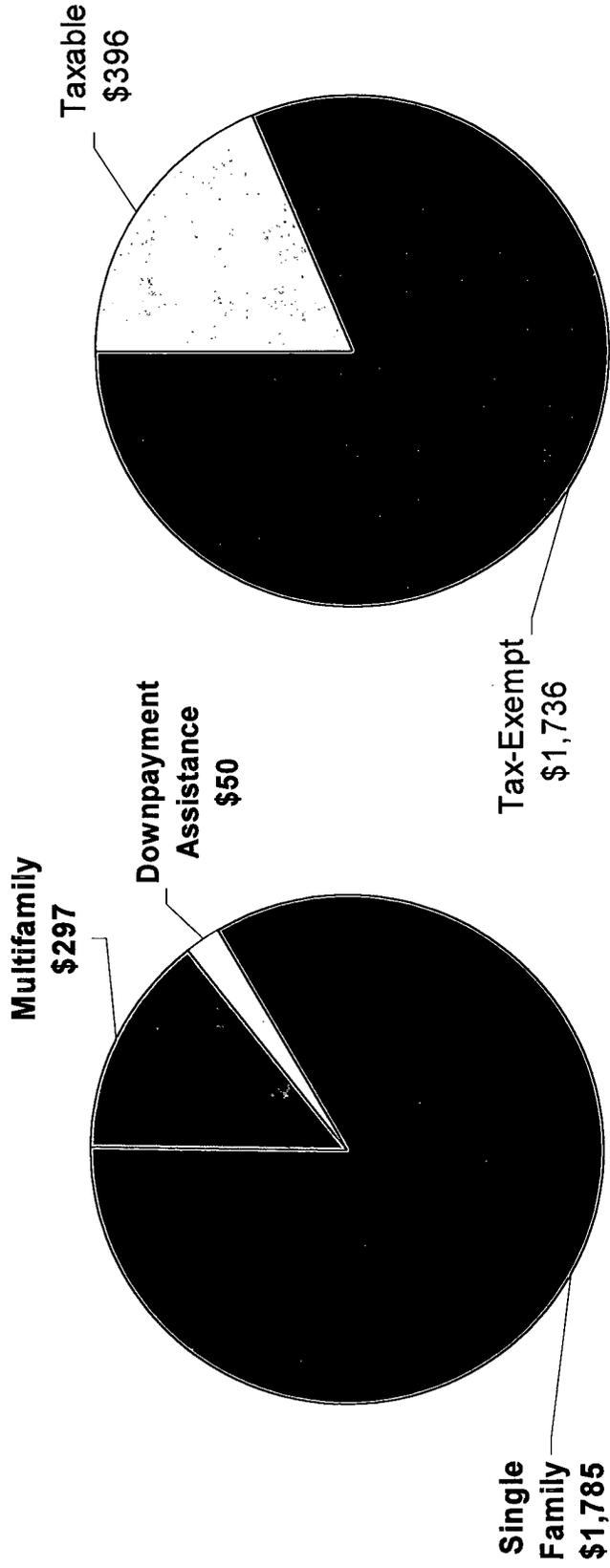
CALIFORNIA HOUSING FINANCE AGENCY

2004 BOND SALE SUMMARY  
CALENDAR YEAR JANUARY-DECEMBER

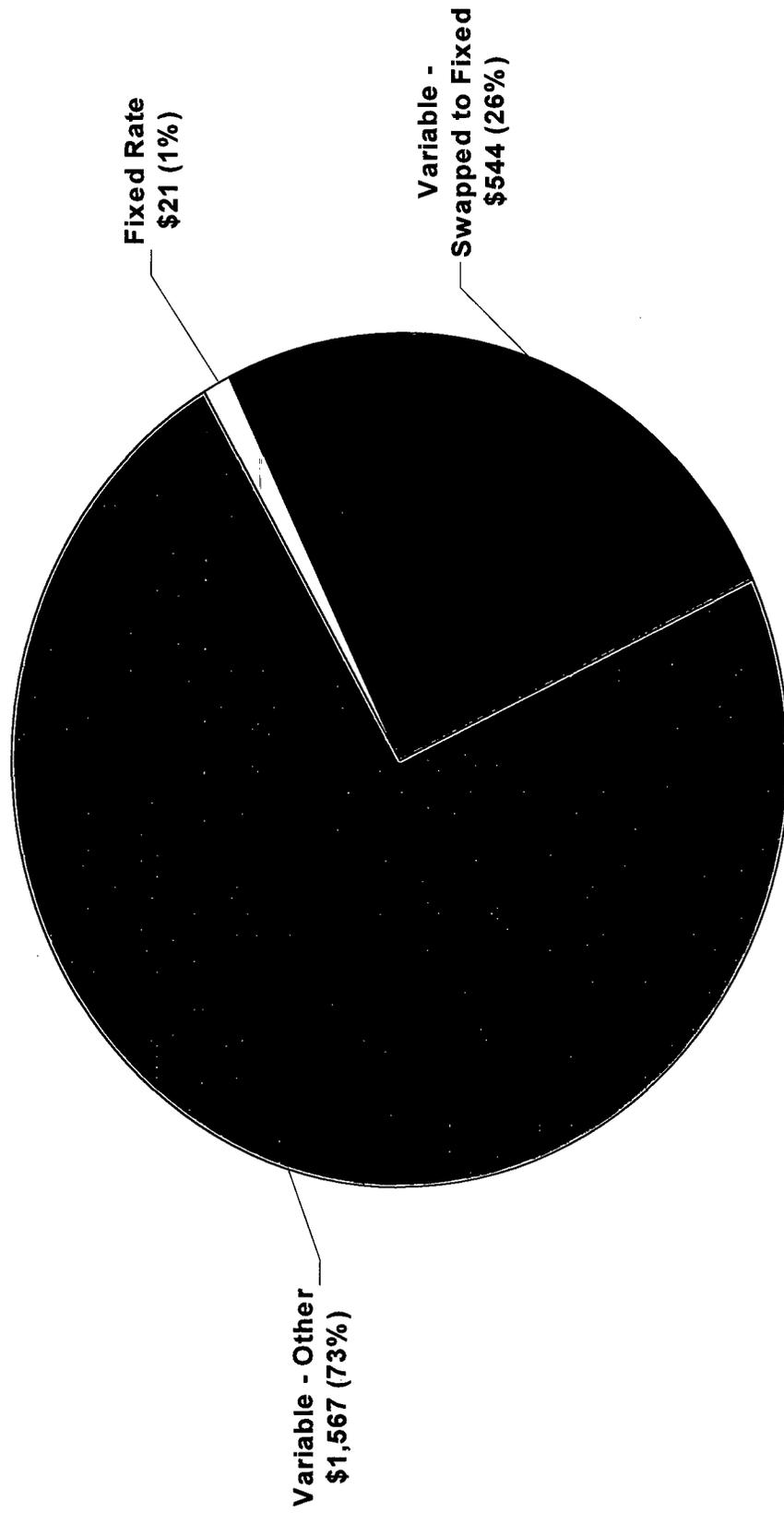
	<u>SINGLE FAMILY</u>	<u>MULTIFAMILY</u>	<u>SINGLE FAMILY DOWN PAYMENT ASSISTANCE</u>	<u>TOTALS</u>
<b>TAX-EXEMPT BONDS</b>				
Variable Rate				
VRDO's	\$359,105,000	\$0	\$50,000,000	\$409,105,000
Auction Bonds	\$0	\$275,425,000		\$275,425,000
Indexed-Floaters	\$1,009,370,000	\$21,555,000		\$1,030,925,000
Fixed Rate	\$20,895,000	\$0		\$20,895,000
<b>TAX-EXEMPT TOTALS</b>	<b>\$1,389,370,000</b>	<b>\$296,980,000</b>	<b>\$50,000,000</b>	<b>\$1,736,350,000</b>
<b>TAXABLE BONDS</b>				
Variable Rate				
Indexed-Floaters	\$396,305,000	\$0	\$0	\$396,305,000
<b>TAXABLE TOTALS</b>	<b>\$396,305,000</b>	<b>\$0</b>	<b>\$0</b>	<b>\$396,305,000</b>
<b>GRAND TOTALS</b>	<b>\$1,785,675,000</b>	<b>\$296,980,000</b>	<b>\$50,000,000</b>	<b>\$2,132,655,000</b>

# CalHFA Bonds 2004 Calendar Year

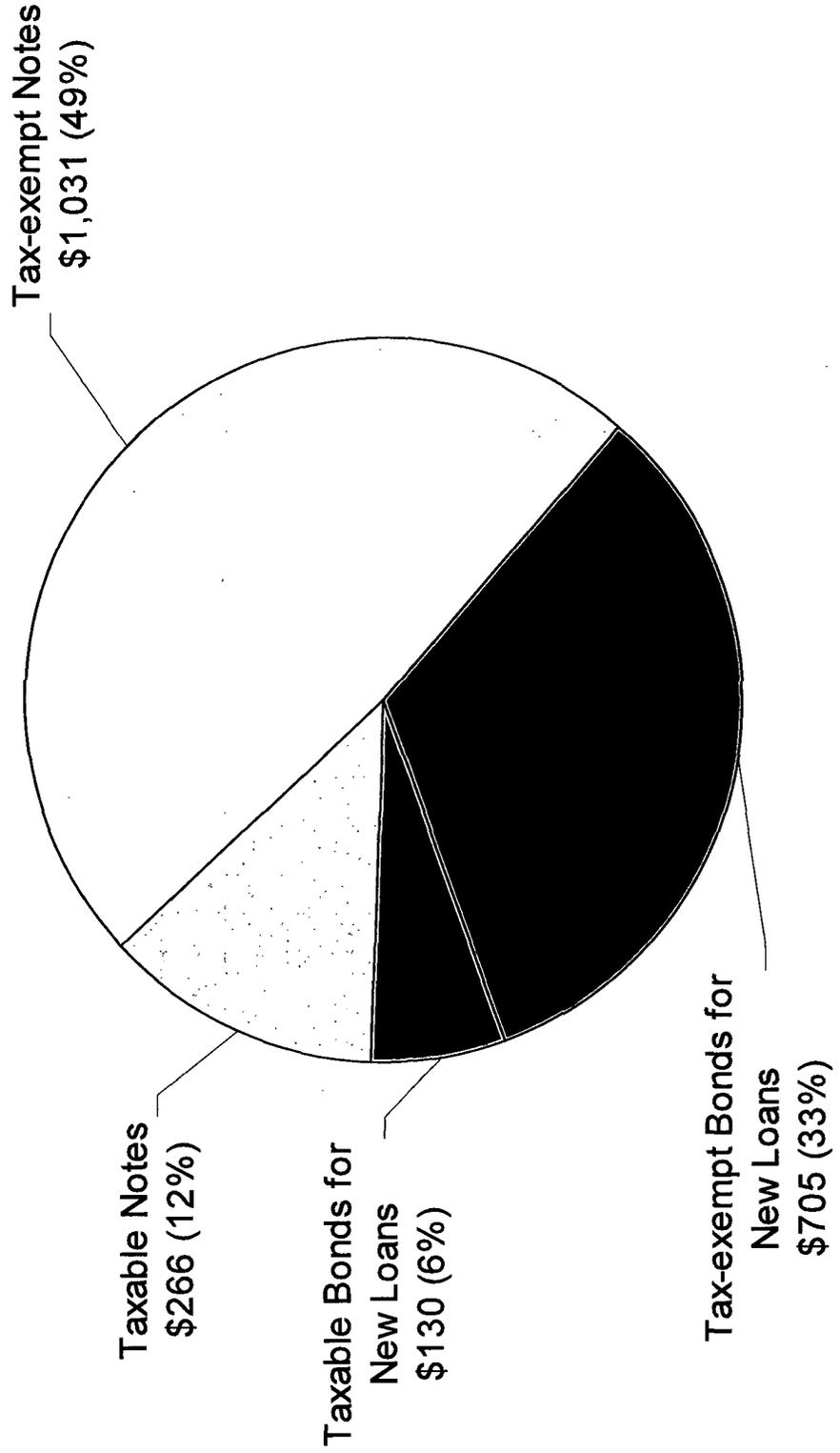
(in millions)



**CalHFA Fixed Rate and Variable Rate Bonds  
Issued in Calendar Year 2004  
(\$ in Millions)**



**CalHFA Tax-exempt and Taxable Bonds  
Issued in Calendar Year 2004  
(\$ in Millions)**



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**MEMORANDUM****To:** Board of Directors**Date:** December 28, 2004**From:** Bruce D. Gilbertson, 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

This report describes the variable rate bonds and notes of CalHFA and is organized programmatically by indenture as follows: HMRB (Home Mortgage Revenue Bonds--CalHFA's largest single family indenture), MHRB (Multifamily Housing Revenue Bonds III--CalHFA's largest multifamily indenture), HPB (Housing Program Bonds--CalHFA's newest indenture, used to finance the Agency's downpayment assistance loans), and DDB (Draw Down Bonds used to preserve tax-exempt authority.) The total amount of CalHFA variable rate debt is \$6.4 billion, 80% of our \$8 billion of total indebtedness as of December 31, 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 ( <i>\$ in millions</i> )			
	Tied Directly to Variable Rate <u>Assets</u>	Swapped to <u>Fixed Rate</u>	Not Swapped or Tied to Variable Rate <u>Assets</u>	Total Variable <u>Rate Debt</u>
HMRB	\$4	\$3,306	\$962	\$4,272
MHRB	0	795	306	1,101
HPB	0	35	15	50
DDB	<u>1,009</u>	<u>0</u>	<u>0</u>	<u>1,009</u>
Total	\$1,013	\$4,136	\$1,283	\$6,432

Our net exposure includes \$266 million of taxable note proceeds that are currently invested at a fixed rate. One year ago our net exposure was \$850 million and 11% of our indebtedness. Two years ago it was \$692 million and 8.3 % of our indebtedness; three years ago it was \$741 million and 9.6%.

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, the interest earnings rate for the State Treasurer's investment pool, where we invest much of our bond proceeds, is currently at 2.12%. 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 resetting at approximately 2.24%.

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 *	\$137	\$790	\$927
Long average life	<u>190</u>	<u>166</u>	<u>356</u>
TOTALS	\$327	\$956	\$1,283

\* Bonds with an expected average life of 10 years or less.

#### FIXED-PAYER INTEREST RATE SWAPS

Currently, we have arranged a total of 109 “fixed-payer” swaps with ten different counterparties for a combined notional amount of \$4.2 billion. Included in this total is \$34 million of anticipatory swaps for multifamily bonds that are expected to be issued next year. 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>
HMRB	\$2,114	\$1,210	\$3,324
MHRB	828	0	828
HPB	<u>35</u>	<u>0</u>	<u>35</u>
TOTALS	\$2,977	\$1,210	\$4,187

The following table shows the diversification of our fixed payer swaps among the ten 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 other firms. 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-	\$ 835.8	18
MLDP, AG	Aaa	AAA	AAA	348.2	12
Citigroup Financial Products Inc.	Aa1	AA-	AA+	825.7	20
Bear Stearns Financial Products Inc.	Aaa	AAA	NR	659.0 326.5 *	11 8 *
Lehman Brothers Derivative Products Inc.	Aaa	AAA <sup>t</sup>	NR	638.4	22
AIG Financial Products Corp.	Aaa	AAA	AAA	254.5	8
Goldman Sachs Mitsui Marine Derivative Products, L.P.	Aaa	AA+	NR	164.4 346.7 *	4 5 *
JP Morgan Chase Bank	Aa3	AA-	AA-	145.7	6
Bank of America, N.A.	Aa1	AA-	AA-	128.8	4
BNP Paribas	Aa2	AA-	AA	100.0	2
UBS AG (Union Bank of Switzerland AG)	Aa2	AA+	AA+	<u>86.7</u>	<u>2</u>
				\$4,187.2	109

\* *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 August 1, 2004 semiannual debt service payment date we made a total of \$62.2 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. In the past we entered into swaps at a ratio of 65% of LIBOR, the London Inter-Bank Offered Rate which is the index used to benchmark taxable floating rate debt. These percentage-of-LIBOR swaps have afforded us with excellent liquidity and great savings when the average BMA/LIBOR ratio was steady at 65%. But 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 81.6%. The BMA (Bond Market Association) index is the index used to benchmark 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 \$1.4 billion of new LIBOR-based swaps using this new formula, and we expect to continue to use this formula. In addition, we currently have basis swaps for \$673 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. As an example, we saved nearly \$745 thousand on our 8/1/04 swap payments by entering into the basis swaps. The following table shows the diversification of variable rate formulas used for determining the payments received from our interest rate swap counterparties.

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	\$1,417	\$0	\$1,417
3 mo. LIBOR + spread	0	746	746
BMA – 15bps	509	0	509
1 mo. LIBOR	0	386	386
Enhanced LIBOR <sup>1</sup>	347	0	347
Stepped % of LIBOR <sup>2</sup>	326	0	326
65% of LIBOR	315	0	315
6 mo. LIBOR	0	77	77
64% of LIBOR	40	0	40
60% of LIBOR + 21bps	<u>24</u>	<u>0</u>	<u>24</u>
TOTALS	\$2,978	\$1,209	\$4,187

<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%.

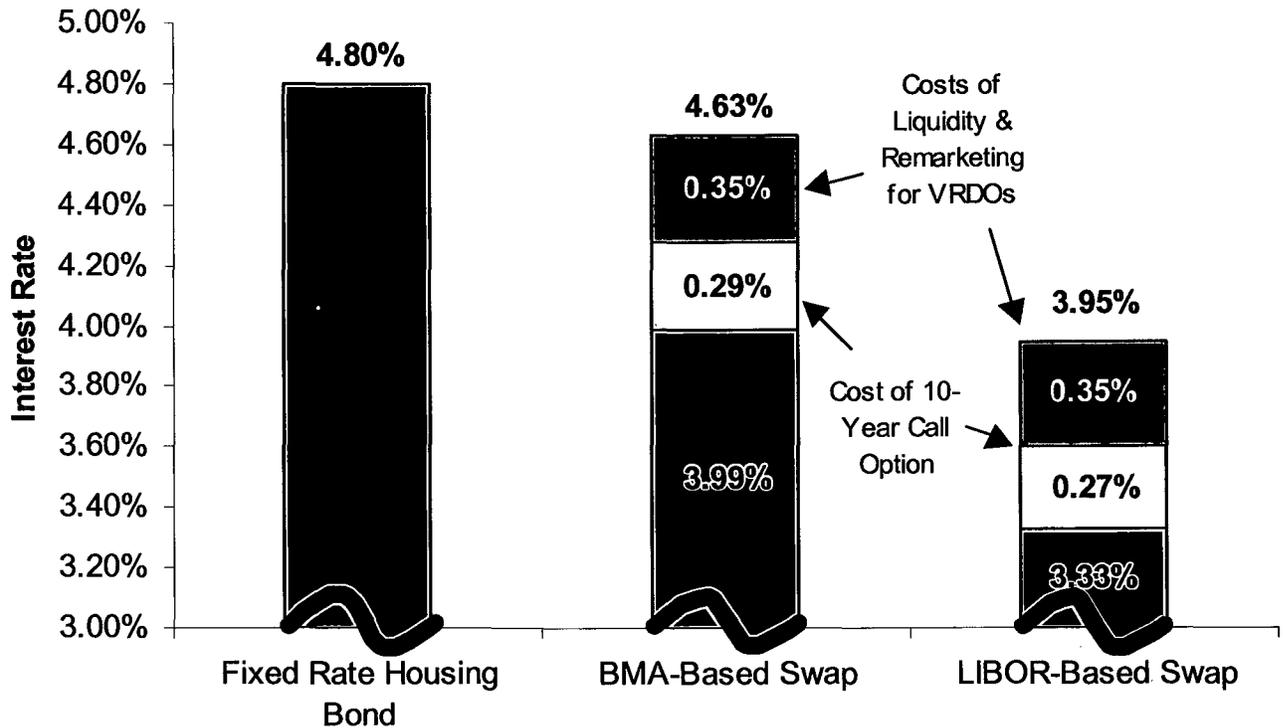
**RISK OF CHANGES TO TAX LAW**

For an estimated \$2.5 billion of the \$3 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 \$330 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, 33.8% of our \$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.

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 October 29, 2004)



BMA-Based Swap: BMA Index – 15 bps  
 LIBOR-Based Swap: 60% LIBOR + 26 bps

**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 \$4.6 billion of prepayments, including over \$1.4 billion in 2004. Of this amount, approximately \$427 million is “excess” to swapped transactions we entered into between 2000 and 2003. In other words, our current loan portfolios for these 2000 through 2003 bond transactions have shrunk to amounts that are \$427 million less than the current “notional” amounts of the interest rate swaps.

Also of interest is a \$17.3 million forced mismatch between the notional amount of certain of our swaps and the outstanding amount of the related bonds. This mismatch has 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 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 initially invest most 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.

In consultation with our financial advisors, we have determined that the best long-term strategy is 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 December 31, 2004 transfer of loans from our warehouse line we have recycled a total of \$770.7 million of excess prepayment moneys over the past year and a half. This practice has resulted 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).

Monthly 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 have generally been falling. Growth in the portfolio combined with this 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.

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 (\$ in millions)</u>
3/31/03	(\$345.1)
5/31/03	(\$450.4)
6/30/03	(\$409.9) <sup>1</sup>
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)
5/31/04	(\$178.3)
6/30/04	(\$187.2) <sup>2</sup>
7/31/04	(\$230.4)
8/31/04	(\$272.8)
9/30/04	(\$279.3)
10/31/04	(\$296.2)
11/30/04	(\$237.9)

It should be noted that during this period, the notional amount of our fixed-payer swaps has been increasing to our current total of \$4.2 billion. When viewing the termination value, one should consider both the change in market conditions and the increasing notional amount.

<sup>1</sup> As reported in our 2002/03 financial statements.

<sup>2</sup> As reported in our 2003/04 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>
HMRB	\$186	\$2,810	\$2,284	\$5,280
MHRB	506	0	596	1,102
HPB	<u>0</u>	<u>0</u>	<u>50</u>	<u>50</u>
Total	\$692	\$2,810	\$2,930	\$6,432

**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.

In November 2004 we requested proposals from our existing liquidity banks to provide standby bond purchase agreements for our VRDOs issued under the HMRB indenture during calendar year 2005. We received liquidity bids from nine banks or syndicates of banks totaling in excess of \$2.8 billion. We have selected four banks to provide liquidity for HMRB VRDOs with whom we plan to rotate throughout the coming year. Each of the four banks selected offered very attractive pricing for terms up to 12 years.

LIQUIDITY PROVIDERS  
(*\$ in millions*)

<u>Financial Institution</u>	<u>\$ Amount of Bonds</u>	<u>Indenture</u>
Dexia Credit Local	\$496.8	HMRB
Fannie Mae	474.8	HMRB/MHRB
Lloyds TSB	324.2	HMRB
Bank of Nova Scotia	274.3	HMRB
Bank of America	191.5	HMRB
Landesbank Hessen-Thuringen	177.4	MHRB
JPMorgan Chase Bank	176.3	HMRB/MHRB
KBC	139.2	HMRB
Westdeutsche Landesbank	123.4	HMRB
Bayerische Landesbank	112.0	HMRB
State Street Bank	102.0	HMRB
BNP Paribas	100.0	HMRB
Bank of New York	99.0	HMRB
CalSTRS	88.8	HMRB/MHRB
Citigroup, N.A.	<u>50.0</u>	HPB
Total	\$2,929.7	

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.

**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.