



# REPORTS

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State of California

**MEMORANDUM**

**To:** Board of Directors

**Date:** October 20, 2005



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

**Subject:** ANNUAL INVESTMENT REPORT

In 1995 the Board adopted an investment policy and asked for a periodic investment report. Attached for your information is an investment report as of June 30, 2005, the end date for the most recent fiscal year. This report shows that CalHFA moneys continue to be invested conservatively and in accordance with the Board-approved investment policy.

INVESTMENT REPORTSUMMARY

As of June 30, 2005, CalHFA had \$9.5 billion of assets, of which \$3.7 billion (39%) consisted of investments (not mortgages). \$600 million of this \$3.7 billion was used to pay bond debt service and swap payments due on August 1, 2005. For the fiscal year, CalHFA total revenues were \$517 million, of which \$121 million (23%) was investment interest income.

The following table shows the types of investments we hold for different categories of funds. Note that (the same as for the previous fiscal years) investment agreements are our most prevalent type of investment and are used exclusively in conjunction with our bond financing programs. As before, our next most prevalent investment is the State's investment pool. The balances in the investment agreements have increased by \$508 million from last year primarily due to the increase in single family loan prepayments. As of June 30th, \$522 million of single family loan principal prepayments were being held for recycling into new mortgage loans.

<u>Investment Type</u>	AMOUNT INVESTED <i>(\$ in millions)</i>		<u>Total</u>
	<u>Bond Moneys</u>	<u>Non-Bond Moneys</u>	
Investment agreements	\$2,604.9	\$0.1	\$2,605.0
State investment pool	532.6	494.6	1,027.2
Securities (fair market value)	51.7	8.5	60.2
Money market and Bank deposit	<u>27.6</u>	<u>8.7</u>	<u>36.3</u>
Totals	\$3,216.8	\$511.9	\$3,728.7

**INVESTMENT AGREEMENTS**

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

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

INVESTMENT AGREEMENT BALANCES  
(*\$ in millions*)

	<u>Bond Proceeds</u> (For Loan Purchases)	<u>Drawdown</u> Bond Proceeds	<u>Reserve</u> Funds	<u>Debt Service</u> Funds	<u>Totals</u>
Single Family	\$219.6	\$931.5	\$92.7	\$876.5	\$2,120.3
Multifamily	<u>343.6</u>	<u>21.6</u>	<u>7.0</u>	<u>112.5</u>	<u>484.7</u>
Totals	\$563.2	\$953.1	\$99.7	\$989.0	\$2,605.0

The first two attachments show information about our \$2.6 billion of deposits with financial institutions providing us with investment agreements. Note the high credit ratings of the institutions. If these credit ratings were to fall below a certain threshold level, we have the right to request collateralization or return of principal.

**STATE INVESTMENT POOL**

As shown by the table on the previous page, we have more than \$1.0 billion invested with the State Treasurer in the State investment pool, which, over time, has given us security, a fair return (2.851% during June), complete liquidity, and administrative simplicity.

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

**SECURITIES**

The third attachment displays information about the \$60.2 million (fair market value) of securities we hold. This category includes \$49.1 million of Fannie Mae, Ginnie Mae, and Linda Mae securities backed by loans originated for our single family and multifamily programs. Note that the market value of the securities is greater than the amortized value because of declines in interest rates since the securities were obtained.

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

**MONEY MARKET AND BANK DEPOSITS**

Our outside trustee sweeps overnight deposits into a treasury securities money market fund which was paying 2.37% as of June 30. The amount invested in the money market includes some bond program moneys which we expect to use to purchase loans or mortgage backed securities or to pay costs of issuance. In addition, this category includes loan servicing revenues held in bank deposit accounts.

California Housing Finance Agency  
 Funds Invested in Investment Agreements  
 As of June 30, 2005  
 Totals by Financial Institution Ratings

<u>Moody's Ratings</u>	<u>Amount Invested</u>	<u>Percentage of Total Invested</u>
Aaa	\$ 1,266,097,522	48.61%
Aa1	9,936,561	0.38%
Aa2	585,420,442	22.47%
Aa3	743,552,689	28.54%
Total	<u>\$2,605,007,214</u>	<u>100.00%</u>

<u>S &amp; P Ratings</u>		
AAA	\$ 617,610,804	23.72%
AA	785,361,085	30.15%
AA-	552,125,269	21.19%
A+	1,423,338	0.05%
A	<u>648,486,718</u>	<u>24.89%</u>
Total	<u>\$2,605,007,214</u>	<u>100.00%</u>

SUMMARY OF CALIFORNIA HOUSING FINANCE AGENCY FUNDS DEPOSITED IN INVESTMENT  
AGREEMENTS - JUNE 30, 2005

INVESTMENT AGREEMENT PROVIDER	MOODY'S RATING	STANDARD & POOR'S RATING	AMOUNT INVESTED
Bayerische Landesbank	Aaa	A	\$ 648,486,718
American International Group Matched Funding Corp. (AIGMFC)	Aa2	AA	472,599,354
Societe General	Aa3	AA-	437,835,473
Aegon Institutional Markets	Aa3	AA	303,019,762
Trinity	Aaa	AAA	251,652,024
Rabobank Int.	Aaa	AAA	187,139,812
Royal Bank of Canada	Aa2	AA-	109,472,614
CDC Funding	Aaa	AAA	93,936,379
MBIA Inv. Management Corp.	Aaa	AAA	49,615,333
FGIC Cap. Market Services	Aaa	AAA	35,267,256
Bank of America	Aa1	AA	4,306,308
Citibank	Aa1	AA	4,161,545
Westdeutsche LB	Aa2	AA-	3,243,283
Citicorp	Aa1	AA-	1,468,708
Pacific Life Co.	Aa3	AA	1,274,116
Canadian Imperial Bank	Aa3	A+	1,165,571
JPMorganChase 1	Aa3	A+	257,767
Bankamerica Corp.	Aa2	AA-	105,191
Total Funds Invested in Investment Agreements			<u>\$ 2,605,007,214</u>
1. TMG Financial Pruducts' assets were purchased by JPMorganChase.			

## Summary of CalHFA Investments in Securities

As of June 30, 2005

<u>Type of Investment</u>	<u>Par Value</u>	<u>Book Value</u>	<u>Market Value</u>	<u>Weighted Average Coupon</u>	<u>Weighted Average Remaining Maturity</u>
GNMA Securities	\$ 25,495,048	\$ 25,495,048	\$ 26,184,625	5.90%	27.66 Years
FNMA Securities	22,527,539	22,527,539	22,291,768	5.31%	24.52 Years
LNMA Securities	688,451	688,451	585,183	3.00%	6.16 Years
Commercial Paper	7,523,000	7,523,000	7,456,442	98.35%	0.27 Years
U.S. Treasury Bonds	1,346,000	1,213,801	1,643,673	7.73%	15.77 Years
REFCORP Bonds	698,000	809,596	1,025,013	8.63%	15.55 Years
FHLMC Securities	780,000	791,330	1,048,613	8.25%	10.92 Years
<b>Totals</b>	<b>\$59,058,039</b>	<b>\$59,048,765</b>	<b>\$60,235,318</b>		

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State of California

**MEMORANDUM**

**To:** Board of Directors

**Date:** October 25, 2005



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

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

For a number of years the Agency has used variable rate debt as a the primary issuance strategy in providing capital to support its programmatic goals. Most of our interest rate exposure from variable rate debt is hedged in the swap market. This strategy has enabled us to achieve a significantly lower cost of funds and a better match between assets and liabilities.

The following report describes our variable rate bond and interest rate swap positions as well as the related risks associated with this financing strategy. 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 \$6.3 billion, 87% of our \$7.2 billion of total indebtedness as of October 1, 2005. As shown in the table below, our "net" variable rate exposure is \$893 million, 12.4% 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	Not Swapped or Tied to Variable Rate <u>Assets</u>	Total Variable Rate Debt
HMRB	\$4	\$3,677	\$593	\$4,274
MHRB	45	813	285	1,143
HPB	0	35	15	50
DDB	<u>808</u>	<u>0</u>	<u>0</u>	<u>808</u>
Total	\$857	\$4,525	\$893	\$6,275

One year ago our net exposure was \$1.2 billion and 15% of our indebtedness. Two years ago it was \$860 million and 11 % of our indebtedness; three years ago it was \$666 million and 8.5%.

As discussed in each previous report, our \$893 million of net exposure provides a useful internal balance sheet hedge against today's rising interest rate environment, where we are experiencing fast loan prepayments in spite of rising rates. For example, the interest earnings rate for the State Treasurer's investment pool, where we invest much of our bond proceeds, is currently at 3.46%. The high incidence of single family loan prepayments since 2001 has caused our portfolio to contract in spite of annual new production. Debt service savings on our unswapped variable rate bonds helps to offset the economic consequences of low investment rates and high prepayments. The interest rates on our unswapped taxable variable rate bonds have been resetting at approximately 3.97%.

In addition, while our current \$893 million of net variable rate exposure is not tied directly to variable rate assets we have \$494.6 million of non-bond funds investments in the State Treasurer's investment pool earning a variable rate of interest. We have determined that the long-term correlation of earnings on the State Treasurer's investment pool and the interest rate paid on unhedged taxable bonds is quite high. Currently the balances in these variable rate investments offset 100% of our net variable exposure.

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 *	\$139	\$412	\$551
Long average life	<u>216</u>	<u>126</u>	<u>342</u>
TOTALS	\$355	\$538	\$893

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

#### **FIXED-PAYER INTEREST RATE SWAPS**

Currently, we have a total of 118 "fixed-payer" swaps with eleven different counterparties for a combined notional amount of \$4.6 billion. Included in this total is \$34 million of anticipatory swaps for multifamily bonds that are expected to be issued later this 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 allows us to continue to offer loan products with 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	\$2,726	\$1,010	\$3,736
MHRB	847	0	847
HPB	<u>35</u>	<u>0</u>	<u>35</u>
TOTALS	\$3,608	\$1,010	\$4,618

The following table shows the diversification of our fixed payer swaps among the eleven 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 our most recent swaps with Merrill Lynch are either with their highly-rated structured subsidiary or we are benefiting from the credit of this triple-A structured subsidiary through a guarantee.

## SWAP COUNTERPARTIES

<u>Swap Counterparty</u>	<u>Credit Ratings</u>			<u>Notional Amounts Swapped</u> <i>(\$ in millions)</i>	<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-	\$ 781.1	18
MLDP, AG	Aaa	AAA	AAA	317.5	12
Merrill Lynch					
Derivative Products Inc.	Aaa	AAA	AAA	105.9	5
Citigroup Financial					
Products Inc.	Aa1	AA-	AA+	846.4	21
Bear Stearns					
Financial Products Inc.	Aaa	AAA	NR	803.9	11
				319.4 *	8 *
Lehman Brothers					
Derivative Products Inc.	Aaa	AAA <sup>t</sup>	NR	565.5	21
Goldman Sachs Mitsui Marine					
Derivative Products, L.P.	Aaa	AA+	NR	316.3	6
				340.2 *	5 *
AIG Financial Products Corp.	Aa1	AA+	NR	246.0	8
Bank of America, N.A.	Aa1	AA	AA	230.1	5
JP Morgan Chase Bank	Aa2	AA-	AA-	143.2	6
BNP Paribas	Aa2	AA	AA	99.9	2
Morgan Stanley					
Capital Services Inc	Aa3	A+	AA-	86.7	1
UBS AG (Union Bank of					
Switzerland AG)	Aa2	AA+	AA+	<u>76.0</u>	<u>2</u>
				\$4,618.5	118

\* *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 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, 2005 semiannual debt service payment date we made a total of \$41.7 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, 81.5% in 2004, and is currently at 64.2%. 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 \$2.1 billion of new LIBOR-based swaps using this new formula. While we expect to continue to use this formula for new swap transactions, we continue to monitor the BMA/LIBOR relationship and benchmark our variable rate bonds to both indexes. Changing market conditions and changes in the BMA/LIBOR relationship could result in the future use of one or more new formulas.

In addition, we currently have basis swaps for \$659 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 have saved \$1.5 million on our swap payments since 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	\$2,058	\$0	\$2,058
3 mo. LIBOR + spread	0	642	642
BMA – 15bps	494	0	494
Enhanced LIBOR <sup>1</sup>	340	0	340
Stepped % of LIBOR <sup>2</sup>	319	0	319
65% of LIBOR	302	0	302
1 mo. LIBOR	0	301	301
6 mo. LIBOR	0	67	67
64% of LIBOR	36	0	36
BMA – 20bps	36	0	36
60% of LIBOR + 21bps	<u>23</u>	<u>0</u>	<u>23</u>
<b>TOTALS</b>	<b>\$3,608</b>	<b>\$1,010</b>	<b>\$4,618</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%.

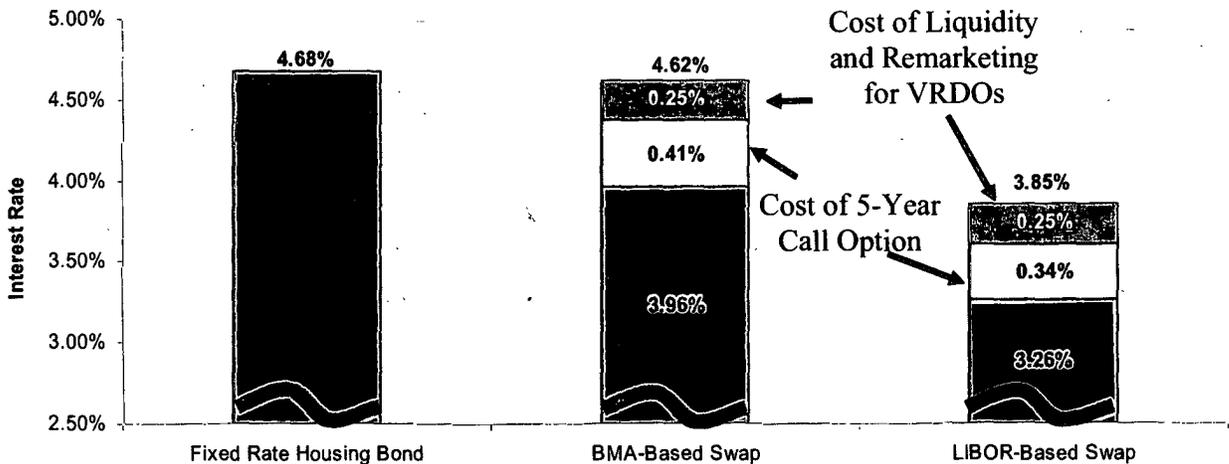
**RISK OF CHANGES TO TAX LAW**

For an estimated \$3.0 billion of the \$3.6 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 \$409 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 \$3.4 billion, 46.6% of our \$7.2 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 24, 2005)**



BMA-Based Swap: BMA Index  
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 generally 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 \$5.6 billion of prepayments, including over \$1.4 billion in 2004 and \$951 million to date in calendar year 2005. Of this amount, approximately \$1.6 billion is “excess” to swapped transactions we entered into. We have since recycled \$1 billion of the \$1.6 billion excess into new loans and have used \$166 million to cross-call high interest rate bonds.

With persistent high levels of prepayments, we have modified the structuring of new swaps by widening the band of expected prepayments. In addition, with the introduction of our interest only loan product we are structuring swap amortization schedules and acquiring swap par termination rights to coincide with the loan characteristics and expectations of borrower prepayment.

Also of interest is a \$60 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 tax-exempt 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 \$893 million 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. In addition, we will monitor the termination value of our “excess swap” position looking for opportunities to unwind these positions when market terminations would be at no cost or a positive value to us. For example, we executed our first termination of swap mismatch in September of this year.

There are several strategies for dealing with 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 rates that will be current at the time we recycle. With our August 1, 2005 transfer of loans from our warehouse line we have recycled a total of \$1 billion of excess prepayments over the past year and a half. This practice has resulted in reduced issuance activity in calendar years 2004 and 2005.

In addition we have begun a widespread strategy of reusing unrestricted loan prepayments to purchase new loans. We currently have more than \$2 billion of swap notional having a fixed payer rate below the weighted average interest rate of new loans being purchased. In today's market, this tremendous recycling opportunity reduces transaction costs related to new issuance and preserves for future use our swap par termination rights.

#### **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 is determined based 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 today, 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 below.

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 the swap notional is excess to the bonds being hedged or 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 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 for the last year.

#### TERMINATION VALUE HISTORY

<u>Date</u>	<u>Termination Value (\$ in millions)</u>
9/30/04	(\$279.3)
10/31/04	(\$296.2)
11/30/04	(\$237.9)
12/31/04	(\$279.0)
1/31/05	(\$292.2)
2/28/05	(\$231.0)
3/31/05	(\$199.1)
4/30/05	(\$252.8)
5/31/05	(\$296.7)
6/30/05	(\$306.9) <sup>1</sup>
7/31/05	(\$235.1)
8/31/05	(\$274.1)

It should be noted that during this period, the notional amount of our fixed-payer swaps has been increasing. 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 2004/05 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>
HMRB	\$168	\$1,265	\$2,840	\$4,273
MHRB	500	0	643	1,143
HPB	0	0	50	50
DDB	<u>0</u>	<u>809</u>	<u>0</u>	<u>809</u>
Total	\$668	\$2,074	\$3,533	\$6,275

**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.

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.

Likewise, in April 2005, we requested liquidity banks to identify new capacity for our MHRB indenture. We received liquidity bids from nine banks totaling in excess of \$1.7 billion, far exceeding our expectations. The newly identified liquidity capacity will allow financing of our multifamily program with variable rate demand obligations rather than auction rate securities as we had been doing since 2003.

LIQUIDITY PROVIDERS  
(*\$ in millions*)

<u>Financial Institution</u>	<u>\$ Amount of Bonds</u>	<u>Indenture</u>
Dexia Credit Local	\$658.7	HMRB
Lloyds TSB	486.6	HMRB
Fannie Mae	445.1	HMRB/MHRB
BNP Paribas	299.6	HMRB
Bank of Nova Scotia	247.8	HMRB
Bank of America	193.6	HMRB
Bayerische Landesbank	174.5	HMRB
Westdeutsche Landesbank	173.4	HMRB
JPMorgan Chase Bank	167.9	HMRB/MHRB
Landesbank Hessen-Thuringen	155.6	MHRB
KBC	120.6	HMRB
State Street Bank	98.1	HMRB
Bank of New York	94.8	HMRB
DEPFA Bank	94.4	MHRB
CalSTRS	72.0	HMRB/MHRB
Citigroup, N.A.	50.0	HPB
Total	\$3,532.7	

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****BMA**

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

**COUNTERPARTY**

One of the participants in an interest rate swap

**DATED DATE**

Date from which first interest payment is calculated.

**DELAYED START SWAP**

A swap which delays the commencement of the exchange of interest rate payments until a later date.

**DELIVERY DATE, OR ISSUANCE DATE**

Date that bonds are actually delivered to the underwriters in exchange for the bond proceeds.

**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.

**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.

**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.

**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.

**MARK-TO-MARKET**

Valuation of securities or swaps to reflect the market values as of a certain date. Represents liquidation or termination value.

**MATURITY**

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

**NOTIONAL AMOUNT**

The principal amount on which the exchanged swap interest payments are based.

**OFFICIAL STATEMENT**

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

**PRICING DATE**

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

**REDEMPTION**

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

**REFUNDING**

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

**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.

**SALE DATE**

Date on which purchase contract is executed evidencing the oral agreement made on the pricing date.

**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.

**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.

**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.

**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.

**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.

**VARIABLE RATE BOND**

A bond with periodic resets in its interest rate. Opposite of fixed rate bond.

State of California

**MEMORANDUM****To:** CalHFA Board of Directors**Date:** 24 October 2005**From:** Di Richardson, Director of Legislation   
CALIFORNIA HOUSING FINANCE AGENCY**Subject:** Legislative Report

Below is the final status of several bills you may be interested in. I have only included information on bills that actually made it to the Governor for final action. There were many other bills that I shared with you throughout the year. As reported, some of those failed passage, and others were made into "Two Year Bills." In my experience, there is no such thing as a truly dead bill until a session ends and the Governor has reported his final actions. Until then, anything can be resurrected. And as this was only the first year of the two year session, we may see new life breathed into some of those bills. I will continue to track those, and will report on any new movements as well as new bills of interest when the Legislature returns in January. If you want to view a copy of any of the bills listed below, all bills can be found at <http://www.leginfo.ca.gov/bilinfo.html>. And, as always, if you have any questions, feel free to give me a call.

**Budget**

**AB 139** (Committee on Budget) State government. (C-07/19/2005)  
**Status:** 07/19/2005-Chaptered by Secretary of State - Chapter No. 74, Statutes of 2005

**Summary:**

This was one of the budget trailer bills. It contained the language which allows funds originally allocated to CalHFA under Proposition 46 for preservation purposes to be used instead, in conjunction with funds from Proposition 63, to help build housing for the chronic homeless. This is part of the Governor's Initiative to Reduce Homelessness.

**CalHFA Sponsor**

**AB 1512** (Garcia) California Housing Finance Agency. (C-09/22/2005)  
**Status:** 09/22/2005-Chaptered by Secretary of State - Chapter No. 338, Statutes of 2005

**Summary:**

This bill authorizes CalHFA's general counsel to designate someone else to act in his or her absence. It also authorizes CalHFA to utilize up to \$75 million of unused funds, originally allocated to the mortgage insurance

program in Proposition 46, to help finance the acquisition, development and construction of affordable residential housing.

- AB 1754** (Committee on Housing and Community Development) **Housing.** (C-09/22/2005)  
**Status:** 09/22/2005-Chaptered by Secretary of State - Chapter No. 348, Statutes of 2005

**Summary:**

This was the Assembly Housing Committee Omnibus Bill. It contained provisions clarifying CalHFA's ability to issue bonds to make loans to local public entities to provide low and moderate income housing; and clarified conflict of interest statutes affecting CalHFA Board members.

### CEQA

- SB 326** (Dunn) **Land use: housing elements.** (C-10/06/2005)  
**Status:** 10/06/2005-Chaptered by the Secretary of State, Chapter Number 598

**Summary:**

This bill expands existing law to provide that any attached housing development is a permitted use (exempt from a CUP on any parcel zoned for housing) if certain criteria is met.

### Construction Defects

- AB 758** (Calderon) **Construction contracts: indemnity.** (C-09/29/2005)  
**Status:** 09/29/2005-Chaptered by the Secretary of State, Chapter Number 394

**Summary:**

Prohibits, after January 1, 2006, residential construction contracts to indemnify a builder by a subcontractor for work outside that contracted for.

### Housing Element

- AB 712** (Canciamilla) **Land use: density.** (V-10/07/2005)  
**Status:** 10/07/2005-Vetoed by Governor

**Summary:**

This bill would have redefined the base residential densities from which local governments could not downzone without up-zoning other properties or making specific findings. The bill would have also deleted the sunset on the requirement that a court award attorney fees and costs to a successful plaintiff, except under extraordinary circumstances.

**Governor's Message:**

I am returning Assembly Bill 712 without my signature. I am concerned about housing affordability in this state and the need to meet the housing demands of Californians. Our local government partners have an important role and tremendous responsibilities in the process. Providing incentives for third parties to sue local governments over housing decisions, as provided in this bill, is inappropriate and does not build any additional housing. The threat of lawsuits diminishes flexibility and creativity when designing a community, and lawsuits divert valuable tax dollars that could be used by local governments. Sincerely, Arnold Schwarzenegger

**(Florez) Housing elements: services. (C-10/07/2005)**

**Status:** 10/07/2005-Chaptered by the Secretary of State, Chapter Number 727

**Summary:**

This bill requires providers of nonagricultural water and sewer services to give priority to lower-income housing developments. It also requires, on or before July 1, 2006 and at least once every five years thereafter, that these public agencies or private entities adopt written policies and procedures, with specific objective standards for provision of these services in conformance with this bill. In addition, this bill requires the Public Utilities Commission to adopt written policies and procedures for use by private water and sewer companies regulated by the Commission. These provisions also apply to charter cities.

**Land Use****SB 435****(Hollingsworth) Housing: density bonuses. (C-10/04/2005)**

**Status:** 10/04/2005-Chaptered by the Secretary of State, Chapter Number 496

**Summary:**

This bill makes a number of amendments to density bonus law.

**Prevailing Wage****SB 940****(Torlakson) Public works. (V-09/07/2005)**

**Status:** 09/07/2005-Vetoed by the Governor

**Current Location:** 09/07/2005-S VETOED

**Calendar Events:****Summary:**

Co-sponsored by Housing California and the Building Trades, this bill would require DIR to publish existing residential prevailing wage rates on the department's web site. (2/22/05)

**Governor's Message:**

I am returning Senate Bill 940 (Torlakson) without my signature. Changes in law made prior to my Administration greatly expanded the type and number of projects that are considered to be public works and thus covered by prevailing wage requirements. Many low-income housing and other residential projects are now subject to prevailing wage requirements, adding additional costs to the groups funding those projects. Unfortunately, the Department of Industrial has less than two-thirds of the information it needs for residential rate determinations. Absent the collective bargaining agreements necessary to establish those missing rates, or some other mechanism by which the department can establish residential rates, a number of residential public works projects are being forced to pay higher commercial rates. This bill does nothing to remedy that deficiency. Instead, this bill imposes a costly mandate on the department to post a patchwork of available residential rates without addressing the underlying problem. The problem is not the failure to publish existing residential rates, but the lack of residential rates for all relevant crafts. I encourage the Legislature to look at this issue more closely next year and send me legislation that truly addresses the problem. Sincerely, Arnold Schwarzenegger

**Redevelopment****SB 527****(Alquist) Redevelopment: senior housing. (C-09/22/2005)****Status:** 09/22/2005-Chaptered by Secretary of State - Chapter No. 262, Statutes of 2005**Summary:**

Adjusts the calculation for determining redevelopment spending on low-income senior housing. Specifically, this bill requires redevelopment agencies to expend low-and moderate-income housing funds (L&M Fund) on housing for seniors, according to the proportion that low-income seniors are represented in the overall low-income population in that community.

**Surplus Property****AB 54****(Negrete McLeod) Surplus state property. (V-10/07/2005)****Status:** 10/07/2005-Vetoed by Governor**Summary:**

Would authorize DGS to sell, exchange, lease, or transfer, various state owned real properties that are deemed surplus to the operational needs of the state.

**Governor's Message:**

I am returning Assembly Bill 54 without my signature. I am greatly concerned with the provisions that were amended into this measure, without the benefit of a public hearing, requiring the Department of General Services (DGS) to initiate a California Environmental Quality Act

(CEQA) process on the properties identified prior to any sale, lease or exchange. This provision has the potential of costing California taxpayers millions of dollars. Applying the CEQA process to these surplus properties prior to sale may result in unnecessary litigation, prolonged escrow periods and missed opportunities for the State to reduce its financial obligations under the voter approved Proposition 60A. Historically, surplus properties have generally been exempted from the CEQA process since the developer must provide for CEQA when the property is eventually developed. Therefore, I am asking DGS to work with the Legislature to correct this unfortunate amendment and pass legislation to exempt the State and these properties from the CEQA process. Until that time, I am unable to sign this bill. Sincerely, Arnold Schwarzenegger

### **Tax Credits**

**SB 950**

**(Torlakson) Housing. (C-10/04/2005)**

**Status:** 10/04/2005-Chaptered by the Secretary of State, Chapter Number 501

**Summary:**

This bill is intended to help preserve the affordability of subsidized housing units when they become eligible for conversion to market rate. Specifically, it:

- Expands the definition of "at risk" as it relates to projects eligible to convert to market rate rents;
- Extends tenant protections currently required for projects financed by cities and counties using bonds to housing authorities and redevelopment agencies that also use bond financing;
- Provides a mechanism under which existing households whose earnings exceed those allowed under a new regulatory agreement can remain in the unit while allowing the owner to reasonably increase the rents on those units.

