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MEMORANDUM**To:** Board of Directors**Date:** August 23, 2006**From:** Bruce D. Gilbertson, Director of Financing
CALIFORNIA HOUSING FINANCE AGENCY**Subject:** REPORT OF BOND SALE AND INTEREST RATE SWAP AGREEMENTS
HOME MORTGAGE REVENUE BONDS 2006 SERIES D, E AND F

On July 27, 2006, the Agency delivered \$240,000,000 of bonds under the Home Mortgage Revenue Bond indenture (HMRB) to Goldman Sachs. The bonds were issued as both tax-exempt fixed rate bonds and tax-exempt variable rate demand obligations, with liquidity provided by Fortis Bank (a new liquidity provider for the Agency). The bonds were issued in three series, HMRB 2006 Series D, HMRB 2006 Series E and HMRB 2006 Series F. All of the Series D and Series E bonds were rated Aaa/AAA by Moody's and Standard & Poor's respectively because of the credit enhancement provided by insuring the bonds with FGIC. The Series F bonds carry the Aa2/AA- ratings of the Home Mortgage Revenue Bonds indenture. Additional details of the bonds are outlined in the attached summary.

The bonds were issued to provide financing for eligible mortgage loans under the Agency's Home Mortgage Purchase Program. The Agency expects that \$155.3 million of the bond proceeds will be used to purchase Interest Only Plus (IOP) loans with interest rates at 6.125% and that \$57.7 million of the proceeds will be used to purchase 30-year loans. An additional \$20 million of the proceeds will be used to purchase loan participations yielding zero percent that will be used in conjunction with the Agency's loan recycling program. The Agency expects to be able to provide homes for approximately 900 families with the proceeds.

The Agency entered into two interest rate swap agreements to provide a fixed rate cost of funds for all of the 2006 Series F Bonds. The swaps are structured with declining notional amounts that match the expected amortization of the corresponding variable rate bonds. For both of the swaps the Agency receives a variable rate of interest based on a percentage of one month LIBOR. Continuing the practice established last year, Bear Stearns was awarded one of the swaps (\$60 million notional) through a competitive bidding process. By competitively bidding swaps on a selective basis the Agency is achieving greater diversification of swap counterparty exposure and better pricing. We estimate the savings in this instance to be approximately \$162,800. We negotiated the price of the second swap with Goldman Sachs, our senior manager for this financing. Additional details of the Swaps are outlined in the attached summary.

SUMMARY OF THE BONDS

BOND SERIES	D	E	F
Par Amount	\$20,000,000	\$100,000,000	\$120,000,000
Type of Bonds (Tax-exempt)	FIXED (serial bonds)	FIXED (serial & term)	VRDO
Tax Treatment	NON-AMT	AMT	AMT
Maturities \$25,000,000, on \$89,005,000, on \$85,995,000, on	8/1/2014-8/1/2017	8/1/2007 – 8/1/2026	8/1/2040 & 2/1/2041
Credit Rating Moody's S&P	Aaa AAA	Aaa AAA	Aa2/VMIG-1 AA-/A-1+
Initial Interest Rate	4.25%-4.40%	4.00 – 5.05%	3.65%
Liquidity Provider	N/A	N/A	Fortis Bank
Insurance Provider	FGIC	FGIC	N/A
Remarketing Agent	N/A	N/A	Goldman Sachs

SUMMARY OF THE SWAPS

SERIES	D	E	F
Notional Amounts Swap #1 Swap #2	N/A	N/A	\$60,000,000 \$60,000,000
Counterparties Swap #1 Swap #2	N/A	N/A	Goldman Sachs MMD Bear Stearns FP, Inc.
Effective Dates Swap #1 Swap #2	N/A	N/A	7/27/06 7/27/06
Fixed Payer Rates Swap #1 Swap #2	N/A	N/A	4.136% 4.255%
Floating Rate Basis Swap #1 Swap #2	N/A	N/A	62% of Libor + 25bps 62% of Libor + 25bps
Reset Frequency Swap #1 Swap #2	N/A	N/A	Monthly Monthly
Maturities Swap #1 Swap #2	N/A	N/A	2/1/2041 8/1/2040

State of California

MEMORANDUM**To:** Board of Directors**Date:** August 23, 2006


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

Subject: DRAW DOWN BOND PROGRAM UPDATE

The following chart summarizes the Draw Down Bond program activity since the last program update, dated December 23, 2005.

Draw Down Bond Program Balances

Single Family Draw Down Bonds	Tax Status	Bonds Outstanding at 1/1/06	Additional Drawings	Redemptions	Bonds Outstanding at 8/1/06
2004 B1	AMT	\$ 475,000,000		\$ 129,170,000	\$ 345,830,000
2004 B2	AMT	\$ 101,425,000		\$ 101,425,000	\$ 0
2005 A	Non-AMT	\$ 67,236,000	\$ 7,254,500	\$ 45,000,000	\$ 29,490,500
2005 B	AMT	\$ 224,000,000	\$ 35,270,000	\$ 9,405,000	\$ 249,865,000
Totals		\$ 867,661,000	\$ 42,524,500	\$ 285,000,000	\$ 625,185,500
Multifamily Draw Down Bonds	Tax Status	Bonds Outstanding at 1/1/06	Additional Drawings	Redemptions	Bonds Outstanding at 8/1/06
2005 A	AMT	\$ 0	\$ 20,365,000	\$ 20,365,000	\$ 0

Within the Single Family program we completed drawings totaling \$42.5 million of tax-exempt refunding authority associated with the February 1 and August 1, 2006 single family bond redemptions.

Additionally, the Home Mortgage Revenue Bonds (HMRB) issued in February, April and July, 2006 used (or redeemed) \$285 million of this Draw Down Bond authority. The HMRB bonds refunded this short-term instrument resulting in long-term bonds being issued to match the expected duration of our single family mortgages.

In December of 2005, the California Debt Limit Allocation Committee awarded CalHFA \$20,365,000 of authority for tax-exempt financing of three multifamily rental housing developments. In February, that authority was used to draw on the Multifamily Draw Down Bonds 2005 A, where it remained until June of 2006. We issued our Multifamily Housing Revenue Bonds III 2006 Series A in the amount of \$76,915,000, which included the refunding of \$20,365,000 of Multifamily Draw Down Bonds 2005 A.

The Draw Down Bond program is one of several available mechanisms for preserving tax-exempt bond authority for future use. Draw Down Bonds are issued in variable rate form and have interest rate resets based on an index. The bonds are privately placed with an investment subsidiary of one of our underwriters and are not rated or insured. Private placement greatly reduces transaction costs and provides useful flexibility, allowing us to easily add additional amounts and to redeem on short notice.

The total amount of tax-exempt authority held in Draw Down Bonds is currently \$625,185,500 as shown in the table above.

State of California

MEMORANDUM**To:** Board of Directors**Date:** August 23, 2006**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 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 a variety of loans including 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, 87% of our \$7.3 billion of total indebtedness as of August 1, 2006.

VARIABLE RATE DEBT (\$ in millions)				
	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	\$3	\$3,889	\$485	\$4,377
MHRB	222	857	175	1,254
HPB	0	35	76	111
DDB	<u>625</u>	<u>0</u>	<u>0</u>	<u>625</u>
Total	\$850	\$4,781	\$736	\$6,367

As shown in the table above, our "net" variable rate exposure is \$736 million, 10% 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. The \$736 million of net variable rate exposure (\$473 million taxable and \$263 million tax-exempt) is offset by the Agency's balance sheet and excess swap positions. While our current net exposure is not tied directly to variable rate assets, we have approximately \$476 million of other Agency funds invested in the State Treasurer's investment pool (SMIF) earning a variable rate of interest. From a risk management perspective, the \$476 million is a balance sheet hedge for the \$736 million of net variable rate exposure.

In order to maintain a certain level of confidence that the balance sheet hedge is effective, we have reviewed the historical interest rates earned on investments in the SMIF and LIBOR interest rate resets (most of our unhedged taxable bonds are index floaters that adjust at a spread to LIBOR). Using the data for the last ten years, we determined that there is a high degree of correlation between the two asset classes (SMIF and LIBOR) and that for every \$1 invested in SMIF we can potentially hedge \$1 of LIBOR-based debt.

The net variable rate exposure is further reduced by two other considerations: 1) as mentioned in the Amortization Risk section of this report, we have \$77 million notional amount of interest rate

swaps in excess of the original bonds they were to hedge, and 2) a portion of our unhedged exposure is tax-exempt debt which resets at the theoretical ratio of 65% of Libor. These two considerations serve to reduce the net effective variable rate exposure to the equivalent of \$593 million of LIBOR-based debt. As a result, the \$476 million of other Agency funds invested in SMIF effectively hedges 80% of our current net variable rate exposure.

In addition, taking unhedged variable rate exposure mitigates the amortization risk without the added cost of purchasing swap optionality. Our unhedged variable rate bonds are callable on any date and allow for bond redemption or loan recycling without the cost of par termination rights or special bond redemption provisions. In addition, taking unhedged variable rate exposure diversifies our interest rate risks by providing benefits when short-term interest rates rise slower than the market consensus. In a liability portfolio that is predominately hedged using long-dated swaps, the unhedged exposure balances the interest rate profile of the Agency's outstanding debt.

FIXED-PAYER INTEREST RATE SWAPS

Currently, we have a total of 130 "fixed-payer" swaps with twelve different counterparties for a combined notional amount of \$4.9 billion. 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	\$3,117	\$849	\$3,966
MHRB	857	0	857
HPB	<u>35</u>	<u>0</u>	<u>35</u>
TOTALS	\$4,009	\$849	\$4,858

The following table shows the diversification of our fixed payer swaps among the twelve 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 & P</u>	<u>Fitch</u>		
Merrill Lynch Capital Services Inc.					
Guaranteed by:					
Merrill Lynch & Co.	Aa3	A+	AA-	\$ 727.8	18
MLDP, AG	Aaa	AAA	AAA	296.0	12
Merrill Lynch					
Derivative Products, AG	Aaa	AAA	AAA	285.2	12
Bear Stearns					
Financial Products Inc.	Aaa	AAA	NR	872.2	13
				306.7 *	8 *
Citigroup Financial					
Products Inc.	Aa1	AA-	AA+	773.1	21
Lehman Brothers					
Derivative Products Inc.	Aaa	AAA ^t	NR	533.8	21
Goldman Sachs Mitsui Marine					
Derivative Products, L.P.	Aaa	AAA	NR	359.3	7
				328.0 *	5 *
AIG Financial Products Corp.	Aa1	AA+	NR	330.4	9
Bank of America, N.A.	Aa1	AA	AA	217.0	5
JP Morgan Chase Bank	Aa2	AA-	AA-	216.3	7
BNP Paribas	Aa2	AA	AA	94.4	2
Morgan Stanley					
Capital Services Inc	Aa3	A+	AA-	86.7	1
UBS AG	Aa2	AA+	AA+	<u>65.7</u>	<u>2</u>
				\$4,857.9	130

* 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, the net periodic payment owed under these swap agreements is from us to our counterparties. As an example, on our August 1, 2006 semiannual debt service payment date we made a total of \$17 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

Almost 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. The only exception is where our taxable floating rate bonds are index-based, as is the case of the taxable floaters we have sold to the Federal Home Loan Banks.

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%. As short-term rates fell to historic lows and with an increased market supply of tax-exempt variable rate bonds, the historic relationship between tax-exempt and taxable rates was not maintained. For example, the average BMA/LIBOR ratio was 77% in 2002, 84.3% in 2003, and 81.5% in 2004. Now that short-term rates have risen significantly, the ratio has begun to fall. In 2005, it averaged 72.5%, and the average for 2006 to date is 68%. 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 revised the formula in December of 2002 to 60% of LIBOR plus 0.26% which resulted in comparable fixed-rate economics but performed better when short-term rates were low and the BMA/LIBOR percentage was high. We have since amassed approximately \$2.1 billion of LIBOR-based swaps using this revised formula. In December 2005 we looked at the formula again and after completing a statistical analysis of CalHFA variable rate bonds as compared to the BMA and LIBOR indexes and taking into consideration the changing market conditions, we've decided to utilize several different swap formulas for our different types of bonds: 64% of LIBOR plus 0.25% for AMT weekly resets; 62% of LIBOR plus 0.25% for AMT daily resets; 64% of LIBOR plus 0.17% for Non-AMT weekly resets; and 62% of LIBOR plus 0.17% for Non-AMT daily resets. We expect to use these new formulas for new swap transactions and we will continue to monitor the BMA/LIBOR relationship and the performance of the new swap formulas.

In addition, we currently have basis swaps for \$635 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 alleviate the effects of high BMA/LIBOR ratios. 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	\$2,090	\$0	\$2,090
3 mo. LIBOR + spread	0	540	540
BMA – 15bps	487	0	487
62% of LIBOR + 25bps	354	0	354
Enhanced LIBOR ¹	328	0	328
Stepped % of LIBOR ²	307	0	307
65% of LIBOR	274	0	274
1 mo. LIBOR	0	251	251
97% of BMA	78	0	78
6 mo. LIBOR	0	57	57
BMA – 20bps	36	0	36
64% of LIBOR	33	0	33
60% of LIBOR + 21bps	<u>23</u>	<u>0</u>	<u>23</u>
TOTALS	\$4,010	\$848	\$4,858

¹ 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.

² 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

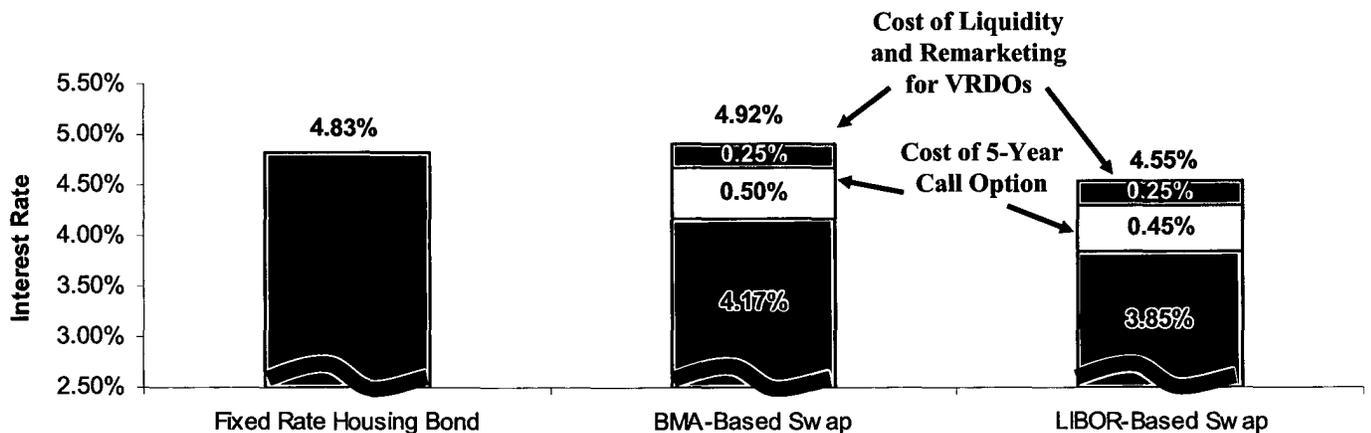
For an estimated \$3.4 billion of the \$4 billion of tax-exempt bonds swapped to a fixed rate, we remain exposed to certain tax-related risks, another form of basis risk. In return for significantly higher savings, we have chosen through these interest rate swaps to retain exposure to the risk of

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 \$459 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 \$3.9 billion, 52.9% of our \$7.3 billion of bonds outstanding. This risk of tax law changes is the same risk that investors take when they purchase our fixed-rate tax-exempt bonds.

The following bar chart shows the current benefit of our ability to assume the risk of changes to tax laws. Over the last several years this benefit (the difference between the cost of fixed rate housing bonds and the cost of a LIBOR based interest rate swap financing) has been as great as 100 basis points, and was the engine that made our interest rate swap strategy effective. In today's market this benefit is only 28 basis points. This reduced benefit has led to recent decisions to issue fixed rate housing bonds for our homeownership programs. As market conditions change we will alter our financing strategies to obtain the lowest cost of borrowing while balancing the associated risks and benefits of alternative structures.

**Costs of Funds for Fixed-Rate Bonds and Synthetic Fixed-Rate Bonds
(Variable Rate Bonds Swapped to Fixed)
(All Rates as of August 14, 2006)**



BMA-Based Swap: BMA Index x 101%
LIBOR-Based Swap: 64% LIBOR + 25 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 \$6 billion of prepayments, including over \$1.4 billion in 2004, \$1.1 billion in calendar year 2005 and \$307 million in 2006 to date. Of this amount, approximately \$1.9 billion is “excess” to swapped transactions we entered into. We have since recycled \$1.7 billion of the \$1.9 billion excess into new loans and have used \$166 million to cross-call high interest rate bonds.

While these persistent high levels of prepayments have eased, 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 \$77 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 “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.

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, 2006 transfer of loans from our warehouse line we have recycled a total of \$1.7 billion of excess prepayments since March 1999. 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 \$3 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. Because termination is an unlikely event, the fact that our swap portfolio has a 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.

Currently, the Government Accounting Standards Board only requires that our balance sheet and income statement be adjusted for the market value of our swaps in excess of the bonds being hedged. However, it does require that the market value be disclosed for all of our swaps in the notes to our financial statements.

The table below shows the history of the fluctuating negative value of our swap portfolio for the past year.

TERMINATION VALUE HISTORY

<u>Date</u>	<u>Termination Value</u> <u>(\$ in millions)</u>
6/30/05	(\$306.9) ¹
7/31/05	(\$235.1)
8/31/05	(\$274.1)
9/30/05	(\$202.6)
10/31/05	(\$156.1)
11/30/05	(\$151.0)
12/31/05	(\$170.9)
1/31/06	(\$162.4)
2/28/06	(\$148.6)
3/31/06	(\$ 88.6)
4/30/06	(\$ 62.1)
5/31/06	(\$ 41.0)
6/30/06	(\$ 29.1)

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.

¹ 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	\$162	\$1,043	\$3,172	\$4,377
MHRB	475	0	779	1,254
HPB	0	0	111	111
DDB	<u>0</u>	<u>625</u>	<u>0</u>	<u>625</u>
Total	\$637	\$1,668	\$4,062	\$6,367

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 August 2006 we received proposals from liquidity banks to provide standby bond purchase agreements for our VRDOs issued under both the HMRB and MHRB indentures for a six month period ending February 2007. We have received liquidity bids from 11 banks totaling \$3.3 billion. The banks are offering very attractive pricing for terms up to 15 years. We are currently reviewing all the proposals and we expect to identify more than enough liquidity capacity for our issuance needs.

LIQUIDITY PROVIDERS
(\$ in millions)

<u>Financial Institution</u>	<u>\$ Amount of Bonds</u>	<u>Indenture</u>
Dexia Credit Local	\$849.5	HMRB
Lloyds TSB	457.1	HMRB
Fannie Mae	403.9	HMRB/MHRB
BNP Paribas	284.1	HMRB
DEPFA Bank	262.2	MHRB
Bank of Nova Scotia	227.3	HMRB
Calyon	175.0	HMRB
Bank of America	174.1	HMRB
Bayerische Landesbank	162.1	HMRB
JP Morgan Chase Bank	161.7	HMRB
Westdeutsche Landesbank	157.3	HMRB/MHRB
Landesbank Hessen-Thuringen	153.4	MHRB
Fortis	120.0	HMRB
KBC	108.7	HMRB
State Street Bank	96.7	HMRB
Bank of New York	89.4	HMRB
CalSTRS	68.6	HMRB/MHRB
LBBW	61.1	HPB
Citibank N.A.	50.0	HPB
Total	\$4,062.2	

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.

BOND AND SWAP TERMINOLOGY**BMA INDEX**

Bond Market Association Municipal Swap Index. 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.