Moody's
INVESTORS SERVICE

Rating Update: MOODY'S DOWNGRADES CALIFORNIA HOUSING FINANCE AGENCY'S SENIOR UNSECURED RATING TO A3 FROM A2; OUTLOOK IS NEGATIVE

Global Credit Research - 19 Sep 2011

Approximately $1.1 billion of debt affected

California Housing Finance Agency
Housing
CA

Opinion

NEW YORK, Sep 19, 2011 -- Moody's Investors Service has downgraded the senior unsecured rating of California Housing Finance Agency (CalHFA) to A3 from A2 and assigned a negative outlook to the rating. This action affects the ratings on the following outstanding bonds of CalHFA that are supported by the Agency's issuer rating: the Multifamily Housing Revenue Bonds III (MF III Bonds, approximately $ 972 million outstanding) and the Housing Program Bonds (approximately $122 million outstanding). No other ratings are affected. Moody's has also downgraded the rating on CalHFA's Home Mortgage Revenue Bonds (HMRB) to Baa2 from Baa1, also with a negative outlook; this action is discussed in a separate report.

SUMMARY RATING RATIONALE

The downgrade is based on continued pressure on the Agency's overall financial position due to the performance of the HMRB, particularly in light of the recent downgrade of Genworth Mortgage Insurance Corporation (Genworth) to Ba1 from Baa2 which was reflected in today's rating action on HMRB. It also reflects risks related to the Agency's high level exposure of variable rate debt, including, in particular, its exposure to interest rate swap counterparties and of rollover risk of credit and liquidity facilities affecting the MFIII Bonds.

A negative outlook has been assigned reflecting the pressures CalHFA continues to face due to the uncertainty of the timing and pace of the economic and real estate recovery in California and its impact on mortgage losses, fund balances and profitability. The outlook also reflects potential challenges in repayment of bank bonds if credit and liquidity facilities issued under the Temporary Credit and Liquidity Program (TCLP) expire without being replaced or the associated debt refinanced.

Strengths

Strong balance sheet: asset to debt ratios have remained steady, as have fund balances as a percentage of debt; liquid funds which are available to pay near term obligations have also increased

Active and experienced management has focused on improving the Agency's financial position through the financial crisis and mortgage market decline

Strong multifamily loan portfolio, with solid debt service coverage and few delinquencies, contributes to net revenues and asset base

Agency has taken full advantage of federal programs to assist HFAs, including NIBP, TCLP and HHF

Challenges

Severe decline in performance of single family mortgage portfolio has been a key source of losses over the past three years

Large portfolio of interest rate swaps exposes the Agency to significant liquidity challenges as a result of collateral posting requirements, as well as counterparty risk and constraints in debt management

Variable rate debt exposes the Agency to interest rate risk as swaps are terminated and increasing amounts of debt become un-hedged, as well as cash flow challenges caused by potential repayment of bank bonds upon expiration of TCLP liquidity facilities

DETAILED CREDIT DISCUSSION

Financial performance: while the balance sheet is still strong, single family mortgage programs have driven losses.

Despite recent weakening of its financial performance, CalHFA continues to have a balance sheet sufficient to meet its obligations with a margin sufficient to support an A3 rating. The Agency's assets and liabilities decreased beginning in early 2009 as mortgage origination and bond issuance dropped sharply reflecting the financial crisis. Although fund balances declined over the fiscal years ending 6/30/09 and 6/30/10(the most recent available audit), they remained stable or improved as a percentage of bonds outstanding. As of 6/30/10 the Agency had an adjusted combined fund balance of $1.215 billion (16.03% of bonds), down from $1.303 billion as of 6/30/08 (15.14% of bonds). (The combined fund balance is assets less liabilities, after Moody's adjustments, including those in bond indentures but excluding the state-funded Contract Administration Account). The adjusted general fund balance (adjusted assets less liabilities outside of bond indentures) declined from $775.3 million (9.01% of bonds) to $670.4 million (8.85% of bonds). Unaudited statements through 3/31/11 point to continuation of these trends through the most recent fiscal years: as of 3/31/ 11 the adjusted combined fund balance was $1.17 billion (16.87% of bonds) and the adjusted general fund balance was $664.7 million (9.53% of bonds).

The Agency experienced significant operating losses in the fiscal years ended 6/30/09 and 6/30/10 which were driven by two factors: single family mortgage losses and declining income on investments due to low interest rates. Adjusted net operating revenues declined from $31.8 million in FY 08 to $3.8 million in FY 09 to negative $28.8 million in FY 2010 (after gap payments of $43.3 million). For the nine months ended 3/31/11 (unaudited), adjusted net operating revenues were negative $28.3 million, pointing to continued losses during FY 2011.

The impact of single family mortgages is illustrated by isolating payments on the Agency's "gap" mortgage insurance - a form of umbrella mortgage insurance provided on loans in HMRB - as a factor. Gap claims included in these losses increased from $189,000 in FY 2008, to $12.3 million in FY 2009 to $43.26 million in FY 2010; for the nine months ended 3/31/11 gap payments were $48.1 million. If gap payments are excluded therefore the Agency had operating income in each fiscal year ($32 million in FY 08, $16 million in FY 09, and $14.5 million in FY 10; and $19.7 million for the nine month period ended 3/31/1). The future direction of losses on the single family portfolio will continue to be a key driver of the Agency's credit strength.

In addition to operating results, total net revenues have also been driven by non-operating items generated by the Agency's actions to manage its balance sheet through the credit crisis. These included decisions to terminate swaps at market, as well as sales of mortgage assets. Total net revenue declined from $31.9 million for FY 2008 (5.51% of total revenue) to negative $12.4 million (-1.97% of gross revenues) in FY 09 to negative $64 million (-12.39% of gross revenues) in FY 10; unaudited statements point to improved overall results in FY 11.

Liquidity resources have increased from $162 million at 6/30/10 to $283 million as the Agency has worked to improve its available balances. Potential single family losses and potential swap collateral posting continue to keep liquidity in focus as a potential credit challenge.

The relative stability of the balance sheet, despite the impact of three years of the mortgage crisis is an important cushion against potential further losses. The Agency's balance sheet is able to withstand Moody's capital charges related to single family and multifamily lending, interest rate swap exposure and other costs, at a level sufficient to support an A3 rating. Future performance will be driven by potential strains on liquidity levels driven by single family losses and interest rate swap collateral, and longer-term effects of potential terminations of TCLP liquidity facilities.

Single family mortgage performance remains a key source of stress, although some signs of improvement may be developing.

Losses from single family mortgage loan delinquency and foreclosures will continue to be a key source of stress going forward. Single family lending had been the Agency's largest activity; single family programs constitute approximately 81% of bonds and 73% of mortgages outstanding, and are a key driver of profitability and balance sheet changes. Please see today's report on HMRB for further information about the performance of the single family portfolio and the decreased support from mortgage insurance, particularly in light of the downgrade of recent downgrade of Genworth Mortgage Insurance Corporation (GMICO) to Ba1 from Baa2 (negative outlook) which are key factors in today's ratings actions.

Although single family loans had been financed primarily through the HMRB indenture, which is not a general obligation of the Agency, cash flow shortfalls in HMRB resulting from mortgage losses could affect the Agency's General Fund because net interest rate swap payments on HMRB hedges are not obligations of HMRB but rather are general obligations of the Agency. So long as interest rates remain low (so that net swap payments are due to counterparties) the Agency pays the swaps from its operating account, which is reimbursed from HMRB after payment of debt service. Thus any actual cash shortfalls resulting from loan losses may be absorbed by the operating account through reduced swap reimbursements.

Strong attention by management to improvement of single family asset management over the past two years should serve to manage losses to some extent, as should the availability of $1.9 billion of federal Hardest Hit Funds (HHF)for mortgage relief for California homeowners. In addition, we have reviewed cash flows projections for HMRB, as well as liquidity projections for the Agency's general fund, which support the ability to absorb loan losses and meet other obligations to a level sufficient to support the ratings assigned. The levels of losses stemming from single family mortgages will continue to be a key factor going forward.

Interest rate swaps and related collateral posting continue to pose challenges to liquidity and cash flows, but par termination options may reduce collateral posting and swap obligations in the medium term. CalHFA's portfolio of interest rate swaps continues to be a key source of potential stress on cash flows and liquidity resources. A key issue is the collateral posting provisions which require collateral posting by CalHFA (subject to certain thresholds) against the swap mark-to-market value, which has remained materially negative to CalHFA as interest rates have remained low (currently approximately negative $303 million). The Agency currently posts approximately $85 million in collateral, which we consider manageable; projected collateral posting levels at the Baa1 level are considered manageable as well. However, were either of the Agency's issuer ratings (Moody's or S&P) to fall below the Baa1 level - two notches below the current rating - CalHFA could be obligated to post additional collateral of approximately $200 million, which is likely to severely strain or exceed the Agency's liquidity resources.

The Agency purchased rights to terminate many of the swaps (without paying their market value), and exercise of these options is a key mitigant to this risk. The Agency already has significantly reduced its swap book, from approximately $3.2 billion as of October 2010 to approximately $2.7 billion as of August 2011(not including approximately $200 million of basis swaps). Exercise of options will allow reduction to approximately $2 billion as of August 2012 and $1.6 billion as of August 2013, with further reductions in future years. As the swap contracts grow shorter, the decline in notional amount will give rise to significant reduction in mark-to-market value; the Agency estimate that market value (and thus maximum collateral posting exposure) could reach approximately $240 million in 2012 and $160 million in 2013 based on today's very low yield curves. In addition to reducing collateral posting, reducing swaps will increase the Agency's flexibility in managing its variable rate exposure (although it may lead to increased interest rate exposure in HMRB to the extent that variable rate bonds become un-hedged).

Counterparty risk is reasonably diversified among a group of large financial institutions with ratings in the A to Aa ranges: the largest exposures include JPMorgan Chase Bank NA, (rated Aa1/P-1, outlook negative); Bank of America, NA rated Aa3(review for downgrade)/P-1 (on review for downgrade); Citibank rated A1/P-1 (on review for possible downgrade) Goldman Sachs Mitsui Derivative Products, LP (rated Aa1) and Deutsche Bank AG (rated Aa3/P-1, stable). Downgrades of key swap counterparties could adversely affect CalHFA's rating in the future depending on their severity. The swaps have generated basis expense - mismatch between variable rate swap receipts and the variable rate bond payments they are designed to hedge - that have contributed to the operating losses described above.

Potential Termination of Liquidity Facilities May Increase Cash Flow Stress. The potential for expiration of external liquidity facilities is another potential source of stress and a focus of our analysis. In addition to variable rate bonds in HMRB, approximately $669 million VRDOs are outstanding under the Multifamily III Bonds and Housing Program Bond indentures, which are agency general obligation. All of these VRDOs benefit from credit and liquidity facilities under the federal TCLP program. The TCLP facilities expire on or about December 31, 2012; although the US Treasury has indicated its intent to consent to a three-year extension of the facilities (to 12/31/15), the terms of such an extension are not yet known. If the facilities expire at any point before repayment without being modified or replaced, the VRDOs may become bank bonds and bear interest at 1% or more over the prime rate, which would increase the program's interest costs significantly. Moreover, TCLP facilities provide that bank bonds remaining outstanding must be repaid in full in December 2022, which could place significant strain on Multifamily III and Housing Program Bond cash flows. Under various stress cash flow runs there may be shortfalls in interest payments and in funds available to meet repayment in December 2022. The Agency has identified a variety of strategies for addressing this challenge through a combination of refinancing of multifamily project mortgage and redemptions or refunding of VRDOs, and we believe that the Agency's resources are sufficient to address this risk to a level appropriate to the rating assigned.

Multifamily mortgages continue to perform well, although multifamily bond cash flows face challenges in managing TCLP expirations.

The Agency's portfolio of approximately 576 multifamily loans continues to demonstrate strong performance and is a key source of credit strength. The loans demonstrate solid debt service coverage and occupancy of over 96%. The portfolio has had very low delinquency levels and few defaults. Approximately 74% of the loans (by principal balance) benefit from low income housing tax credit equity. 25% of the loans are covered by FHA risk sharing insurance, and 15% have project-based Section 8 contracts.

The Agency's largest program for financing multifamily loans is the Multifamily Housing Revenue Bonds III Indenture (MF III), under which the Agency issued bonds before 2009. The MFI III indenture had $996.9 million of bonds outstanding as of 6/30/10. The bonds are general obligations of the Agency (the largest general obligation program). MF III's mortgage loans show strong performance similar to that of the portfolio as a whole; 83% have low income housing tax credit equity and 26.7% benefit from risk sharing insurance. The MF III bond indenture had adjusted net operating revenues were $18.6 million (against gross revenues of $67.6 million), although the indenture showed an overall loss of $935 thousand after swap terminations.

Management actions remain a positive factor.

Actions by CalHFA's management to address financial issues confronting the Agency, particularly in light of the challenges of severe single family mortgage delinquencies and high exposure to variable rate debt, have contributed positively to our rating assessment. Over the past two years, the Agency has substantially enhanced its single family asset management function and reduced timelines for moving defaulted loans through the pipeline. Successful application of the large HHF award should also contribute to efforts to reduce single family losses.

The Agency's financial managers have also worked proactively to improve the Agency's balance sheet to address the combined effect of the mortgage decline and the financial crisis. Actions have included mortgage loan sales, refinancing of multifamily projects to reduce risk the Agency, negotiation of more favorable terms for swap collateral posting, and exercise of swap termination options to reduce exposure. The Agency also was successful in obtaining a loan from the State of California in late 2010 (despite the State's budget pressures) to refinance the Bay Area Housing initiative, relieving a major source of near-term liquidity pressure.

In addition, the Agency has been proactive in taking advantage of federal programs benefitting State HFAs. These include two new bond indentures under the NIBP program, which provide new platforms for a revival of single family and multifamily lending going forward. The new indentures are not Agency GOs. Federal programs also include TCLP liquidity support for VRDOs and Hardest Hit Funds (HHF) ($1.9 billion) for single family mortgage relief

Outlook

OUTLOOK

A negative outlook has been assigned reflecting the pressures CalHFA continues to face due to the uncertainty of the timing and pace of the economic and real estate recovery in California and its impact on mortgage losses, fund balances and profitability, as well as pressure from swap collateral posting and expiration of TCLP liquidity facilities.

WHAT COULD MAKE THE RATING GO UP

Increase in fund balances and/or profitability

Successful management of single family mortgage loan delinquencies and foreclosures so as to contain or reduce losses

Reduced variable rate bond exposure, including successful replacement of TCLP facilities through new facilities or conversions of bonds to modes not requiring external liquidity, reducing the size of the swap portfolio and/or reducing the potential impacts of swap collateral posting

WHAT COULD MAKE THE RATING GO DOWN

Continued low levels of profitability and/or declines in fund balances

Increases in single family losses, due to future increases in delinquencies/foreclosures, and/or higher than anticipated losses on delinquent/foreclosed loans

A further downgrade of GMICO which provides reinsurance for HMRB mortgages

A significant downgrade of HMRB, impairing the ability of HMRB to reimburse the operating account for swap payments

Increase in variable rate pressures, including especially an increase in swap collateral posting due further declines in interest rates or ratings downgrades, swap counterparty downgrades or other unforeseen counterparty events, or lack of successful transition from TCLP liquidity facilities

The principal methodology used in this rating was Moody's Methodology for Assigning Issuer Ratings to Housing Finance Agencies published in May 2001. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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