Moody's
INVESTORS SERVICE

Rating Update: MOODY'S DOWNGRADES THE LONG-TERM UNDERLYING RATING OF CALIFORNIA HOUSING FINANCE AGENCY'S HOME MORTGAGE REVENUE BONDS TO Baa2 FROM Baa1; OUTLOOK IS NEGATIVE

Global Credit Research - 19 Sep 2011

Approximately $5.1 billion of debt affected

California Housing Finance Agency
Housing
CA

Opinion

NEW YORK, Sep 19, 2011 -- Moody's Investors Service has downgraded the long-term underlying rating on California Housing Finance Agency's (CalHFA's) Home Mortgage Revenue Bonds (HMRB) to Baa2 from Baa1. This action affects approximately $5. 1 billion in bonds outstanding as of 6/30/11. The Aaa/VMIG 1 enhanced ratings assigned to the variable rate demand obligations (VRDOs) issued under the HMRB indenture are based on credit and liquidity support from Fannie Mae and Freddie Mac (the GSEs) under the Temporary Credit and Liquidity Program (TCLP) and are not affected by this action. Moody's has also downgraded CalHFA's general obligation rating to A3 from A2, also with a negative outlook; that action is discussed in a separate report.

SUMMARY RATING RATIONALE

The downgrade reflects the ongoing impact of losses due to mortgage delinquencies and foreclosures, and the diminished protection against those losses provided by mortgage insurance in light of the downgrade of the insurance financial strength rating of Genworth Mortgage Insurance Corporation (GMICO) on May 12, 2011 to Ba1 from Baa2 (outlook negative). It incorporates the conclusion of our review of the level of support attributable to reinsurance from GMICO in line with our revised rating implementation guidance on incorporation of private mortgage insurance into HFA ratings published on September 15, 2011. It also reflects the potential stress to HMRB program cash flows from variable rate debt, including the impact of potential expiration of TCLP liquidity facilities and interest rate exposure in high rate scenarios.

The Baa2 rating reflects the indenture's overcollateralization level (Program Asset to Debt Ratio (PADR) of 1.067x as of the 6/30/10 audit), FHA and other federal mortgage insurance on approximately 31% of mortgages (by principal), the requirement that CalHFA pays interest rate swap payments for HMRB, as well as the program's ability to continue to cover debt service under various stress cash flow projections. Other factors include successful management efforts concerning HMRB's finances and enhanced single family asset management of delinquent loans, an improvement in delinquency trends, and the availability of over $1.9 billion of federal Hardest Hit Fund (HHF) aid being ministered by CalHFA to provide statewide mortgage relief, all of which may point to moderation of mortgage losses going forward.

The outlook is negative due to continued uncertainty about the impact of mortgage losses

in light of continued elevated delinquencies/foreclosures and weakness in the California economy and housing markets.

Strengths

Financial performance: PADR has remained relatively stable through the housing downturn as a percentage of debt

FHA insurance eliminates most of the loan loss risk on approximately 29.4% of mortgage loan principal

Mortgage delinquency and foreclosure levels have diminished over 2011

Net payments due to swap counterparties are an obligation of CalHFA (paid from the Agency's operating account) subject to reimbursement by HMRB from funds available, which improves HMRB cash flow

Stress cash flow scenarios demonstrate the ability of HMRB to repay debt in a variety of scenarios

Challenges

Downgrade of GMICO decreases protection against losses provided by mortgage insurance, particularly when combined with recent depletion of reserves held by California Housing Loan Insurance Fund (CalHLIF, rated C) and reserves held by the Agency for its "gap" insurance

Delinquencies and foreclosures remain at elevated levels, pointing to continued mortgage losses in the near term

Variable rate debt may cause additional stresses on cash flows, as a result of potential repayment of obligations under external credit and liquidity facilities under the TCLP program after their expiration, as well as possible interest rate exposure to the extent that variable rate debt is un-hedged

DETAILED CREDIT DISCUSSION

Legal Security

The bonds are special obligations of CalHFA, payable solely from the revenues, assets and properties pledged under the Indenture, including the single family mortgage loans financed under the Indenture and certain reserve accounts. Approximately 90 Series of Bonds outstanding under the indenture are secured on parity by the pledged assets. The bonds are not obligations of the State of California and are not supported by a general obligation pledge of CalHFA.

Diminished PMI Coverage and Continued Mortgage Losses Are Key Concerns, Although Delinquency Levels have Declined

HMRB's portfolio of approximately 24,000 mortgage loans, with an outstanding principal balance $4.42 billion as of 6/30/11, is a key source of security for the bonds. Diminished support from mortgage insurance is a key driver in today's rating action. As of 6/30/11, 29.4% of the loan portfolio (as a % of principal outstanding) benefits from FHA insurance; 1.40% had VA or RHS insurance, 40.71% had PMI insurance from the California Housing Loan Insurance Fund (CaHLIF), and 28.49% had no primary mortgage insurance but had initial loan-to-value ratios below 80%. The FHA insurance nearly eliminates the risk of loss to HMRB on the loans with that insurance and is an important source of credit support. However, the PMI provided through CalHLIF provides weaker support. CaHLIF was downgraded to C from Caa3 on August 11, 2011, and its reserves have now been depleted; we had previously incorporated CalHLIF's weakened claims paying ability into our analysis. CalHLIF's PMI policies are supported by 75% quota share reinsurance from GMICO, and GMICO continues to pay its share of PMI claims. Our action today reflects the level of support we attribute to the GMICO reinsurance in light of GMICO's downgrade and our revised ratings implementation guidance on PMI coverage. Additional support for loans without FHA insurance was provided by CalHFA's "gap" insurance policy, but reserves for gap insurance also have now been depleted (which had also been factored into the rating previously).

The decline in the size of the portfolio and in levels of delinquency should point to lower levels of foreclosure in the future. Serious delinquencies (loans delinquent 90+ days plus loans in foreclosure) have declined over the past year, from 11.24% at 6/30/10 to 8.44% at 6/30/11, and the number of conventional loans in the program decreased by 13.8% from 15,642 to 13,476. Nevertheless losses are expected to continue at elevated levels in the near term as the Agency works through its pipeline of distressed loans, and the reduced coverage provided by PMI and gap insurance increases our estimate of the severity of loss to HMRB from foreclosures.

CalHFA's enhanced single family asset management and federal mortgage funds are potential mitigants to loan losses. CalHFA has increased its focus on management of delinquent loans, tightening supervision of outside servicers and increasing in-house staffing. This has lead to a reduction in the number of seriously delinquent loans in the pipeline. CalHFA received $1.9 billion of federal Hardest Hit Funds (HHF) in late 2010, and this program has potential to soften the impact of mortgage distress. Although the amount of the HHF funding is significant, implementation to date has been slow, and the impact of HHF on the HMRB portfolio is difficult to assess at this time.

The flow of funds in the HMRB currently provides some assistance in absorbing losses because net payments on interest rate swaps hedging a portion of HMRB's variable rate debt are obligations of CalHFA, rather than the HMRB indenture, and are paid out of CalHFA's Operating Account. In practice HMRB reimburses the Operating Account for such payments, on a semiannual basis to the extent funds are available after debt service. Therefore, while interest rates remain low and net swap payments are in favor of the counterparty, any actual cash flow shortfalls in HMRB may be absorbed indirectly by the Operating Account through reduced swap reimbursements. The benefit will decline over time as the swap portfolio decreases and would not occur if interest rates were to rise and net swap payments were received from counterparties (payments to counterparties are pledged to HMRB).

Variable Rate Debt and Liquidity Expirations May Add to Costs

HMRB's high level of variable rate debt is another key source of potential stress and focus of our analysis. As of 6/30/11, approximately 65% of the HMRB bonds were variable rate debt, including 46% of bonds that were VRDOs and 19 % indexed floaters. All of the VRDOs ($2.35 billion of bonds) benefit from credit and liquidity facilities under the 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 HMRB's cash flows.

Approximately $2.2 billion (67%) of the variable rate debt is hedged with interest rate swaps; the remainder is unhedged, subjecting cash flows to interest rate risk. Swap payments are a general obligation of CalHFA, which is a benefit to HMRB as mark to market and collateral posting obligations, if any, do not fall on HMRB. Going forward, CalHFA plans to exercise par termination options available to reduce the size of its swap portfolio. While swap terminations will increase CalHFA's flexibility in managing its variable rate debt, they will also increase the level of unhedged variable rate debt and increase costs if interest rates rise, creating another potential source of tightening of cash flows.

Financial Performance Provide a Cushion Against Losses.

Moody's views HMRB's over- collateralization and profitability as important measures of the ability of program to withstand the impact of mortgage losses as well as potential effects on changing interest rate markets on variable rate debt. Despite the stresses of mortgage losses and variable rate exposure, PADR has remained above 1.06 since 6/30/08 and stood at 1.069 as of 6/30/10 (1.062 if swap reimbursements are charged back to HMRB); interim unaudited statements indicate that PADR has continued at these levels in the current fiscal year. The adjusted fund balance (after swap payments) stood at $379.4 million at 6/30/10, down from $ 394.95 million at 6/30/09 but relatively constant as a percentage of bonds.

Profitability (net revenue as a % of total revenue) for the period ended 6/30/10 continued to be strong at 31.93%, but this also reflected the accounting change; with swaps returned to HMRB, HMRB showed an small operating profit of $4.4 million (1.42%) for the year. However, the program had an overall loss of $10.14 million (3.2%) after non-operating expenses of approximately $14.6 million (net) resulting primarily from a management decision to terminate interest rate swaps. For the nine-month period ended 3/31/11, unaudited results reflect a small operating profit (after swap reimbursements) but overall profitability of approximately 13% when non-operating revenues are included.

The balance sheet provides an important level of protection for loan losses going forward, particularly with reduced protection from mortgage insurance. Going forward we expect that HMRB's performance will depend on whether mortgage delinquencies and foreclosures continue to abate and the Agency's success at mitigating losses through asset management and application of HHF funds. It will also depend on the Agency's ability to manage potential bank bond exposure upon termination of existing TCLP liquidity facilities, through new or modified liquidity support or redemption of VRDOs.

Cash Flow Projections Demonstrate the Program's Ability to Withstand Stresses.

Moody's has reviewed cash flow projections demonstrating the ability of the program to withstand stress scenarios that combine the potential effects of loan losses, repayment of bank bonds, and rising interest rates. The cash flows include low and rising-interest rate scenarios, as well as scenarios assuming different prepayment speeds from 30% to 500% PSA. While severe combinations of loan losses, high interest rates and bank bond repayments cause significant cash flow stress, we believe that the cash flows demonstrate coverage of these stresses within a range considered appropriate for the rating. Loan loss levels ranged from $417 million to $514 million, and were combined with repayment TCLP bonds at their expected maturity date and appropriate levels of elevated interest rates.

Outlook

The outlook is negative because of continued uncertainty about the impact of future loan losses in light of diminished mortgage insurance coverage and the potential for continued weakness in the California housing markets, as well as uncertainty about the future terms of TCLP facilities and stresses related to variable rate debt.

WHAT COULD MAKE THE RATING GO UP

Substantial improvement in mortgage performance, successful efforts to work through the pipeline of delinquent loans with losses not in excess of levels consistent with the rating

Meaningful reduction in exposure to risks related to variable rate debt, including reductions in levels of variable rate bonds outstanding and successful transition from obligations under TCLP

WHAT COULD MAKE THE RATING GO DOWN

Declining PADR and/or profitability, diminishing the cushion available to the program to absorb losses from mortgages or variable rate bond performance

A further downgrade of GMICO or of other significant counterparties

Sustained or increasing high levels of mortgage delinquencies or foreclosures, resulting in actual or forecast losses at levels higher than anticipated

Future negative events related to variable rate exposure, including downgrades of swap counterparties, other unforeseen counterparty events, or periods of variable rate market disruption

Lack of success in managing TCLP liquidity expirations, through modification or replacement of existing facilities, redemption of VRDOs or careful cash flow management

The principal methodology used in this rating was Moody's Rating Approach For Single Family, Whole-Loan Housing Programs published in May 1999. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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For ratings issued on a program, series or category/class of debt, this announcement provides relevant regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides relevant regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides relevant regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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