CalHFA Master Hedge Policy

Risk Management Procedures

Master Hedge Policy

- Developed to establish guidelines for the use and management of financial derivatives
- Allows for the use of hedges to reduce the interest rate risk of loan commitments
- Will help manage many of the risks inherent in using financial derivatives

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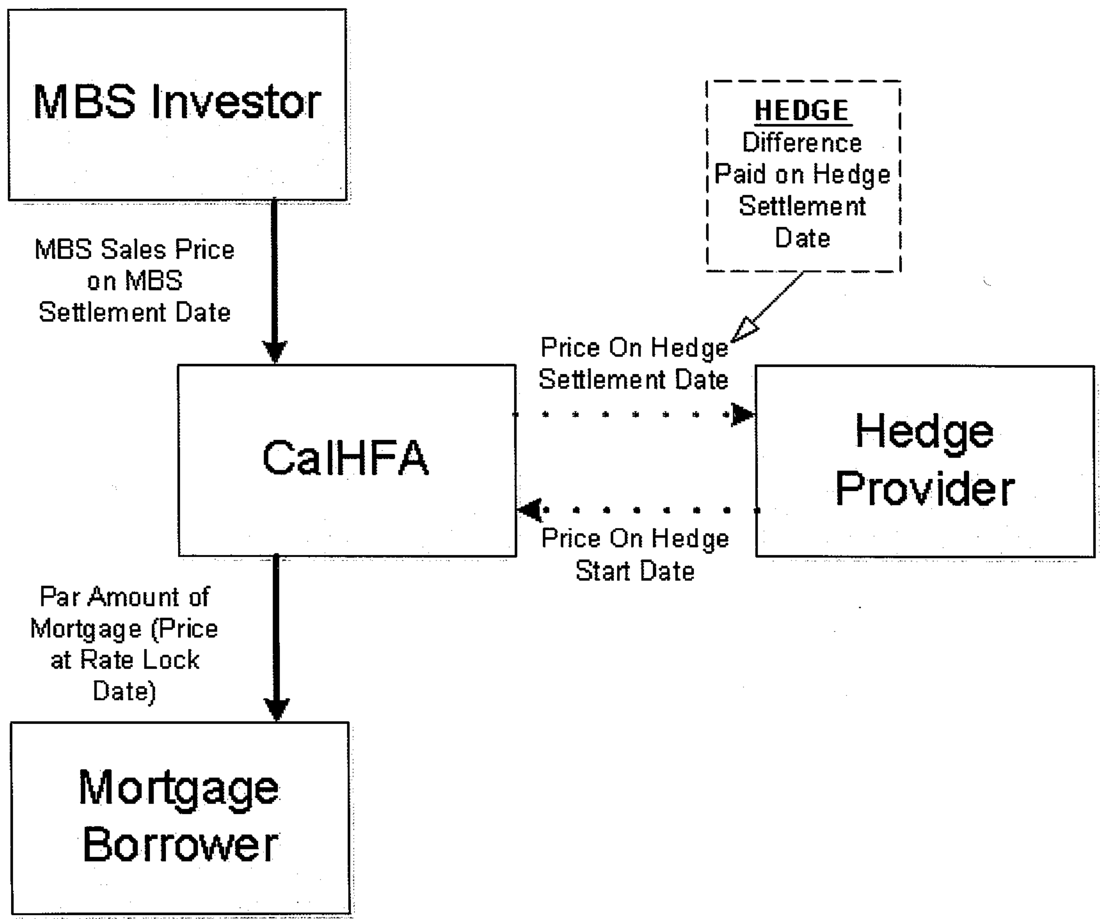
Single-Family Hedge Model



Hedge will offset the financial gains and losses due to the timing difference between the rate lock to the borrower and the securitization of the loan

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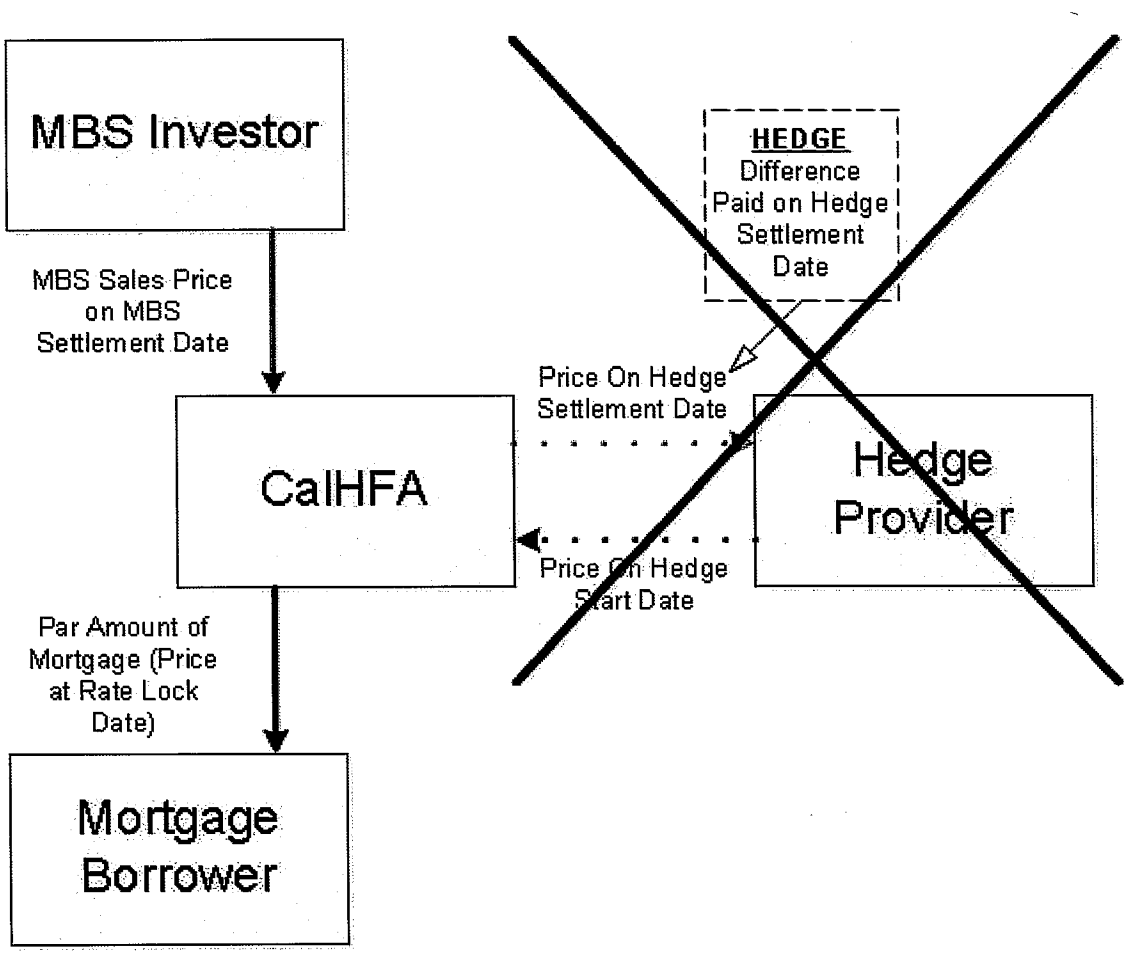
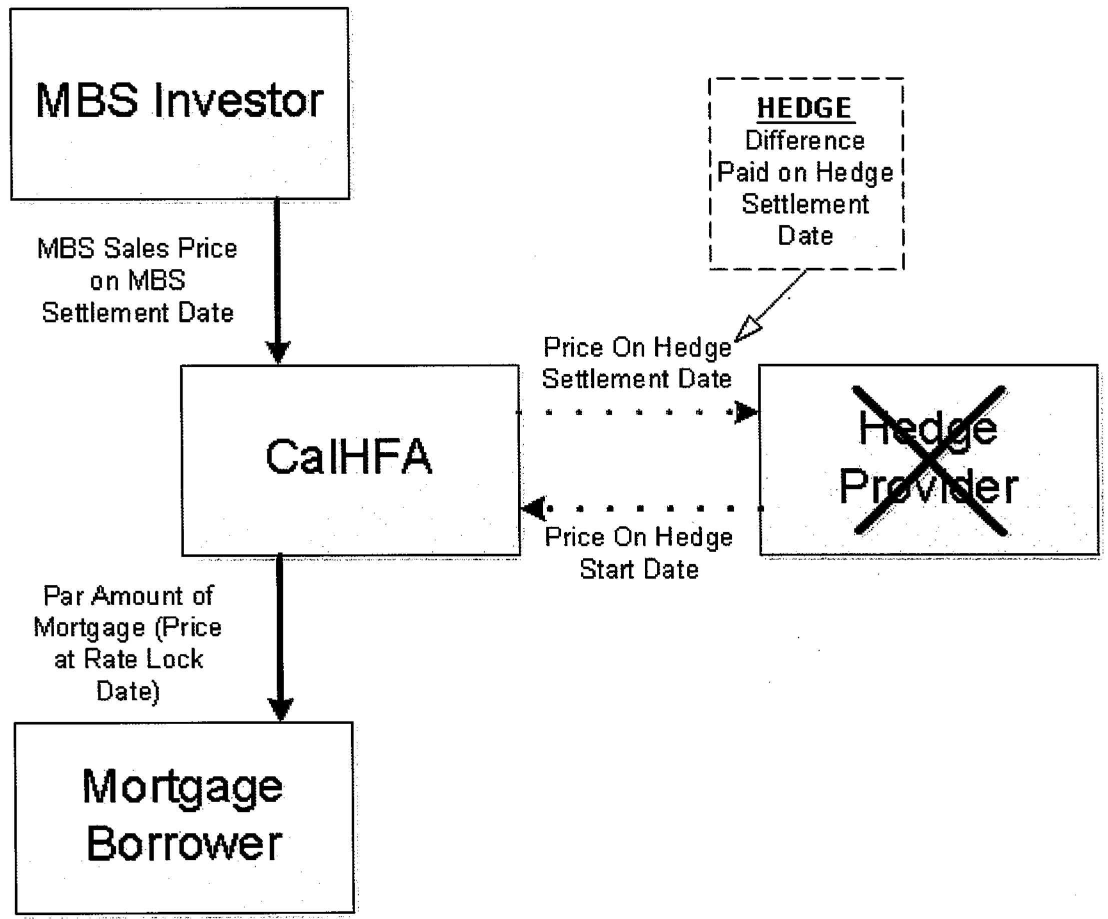
Why Hedge?



- Interest Rate Risk – CalHFA is exposed to interest rate movements on the mortgage rate lock
- As rates rise, MBS prices decrease – when rates fall, MBS prices increase
- If perfectly hedged, interest rate risk is eliminated

Hedge Provider Fails



- Counterparty Risk - hedge provider is unable to meet their obligations
- CalHFA will assume the interest rate risk on the mortgage rate lock
- Only highly rated counterparties will be used with provisions for termination and replacement upon credit events
- Hedges will be spread amongst multiple counterparties

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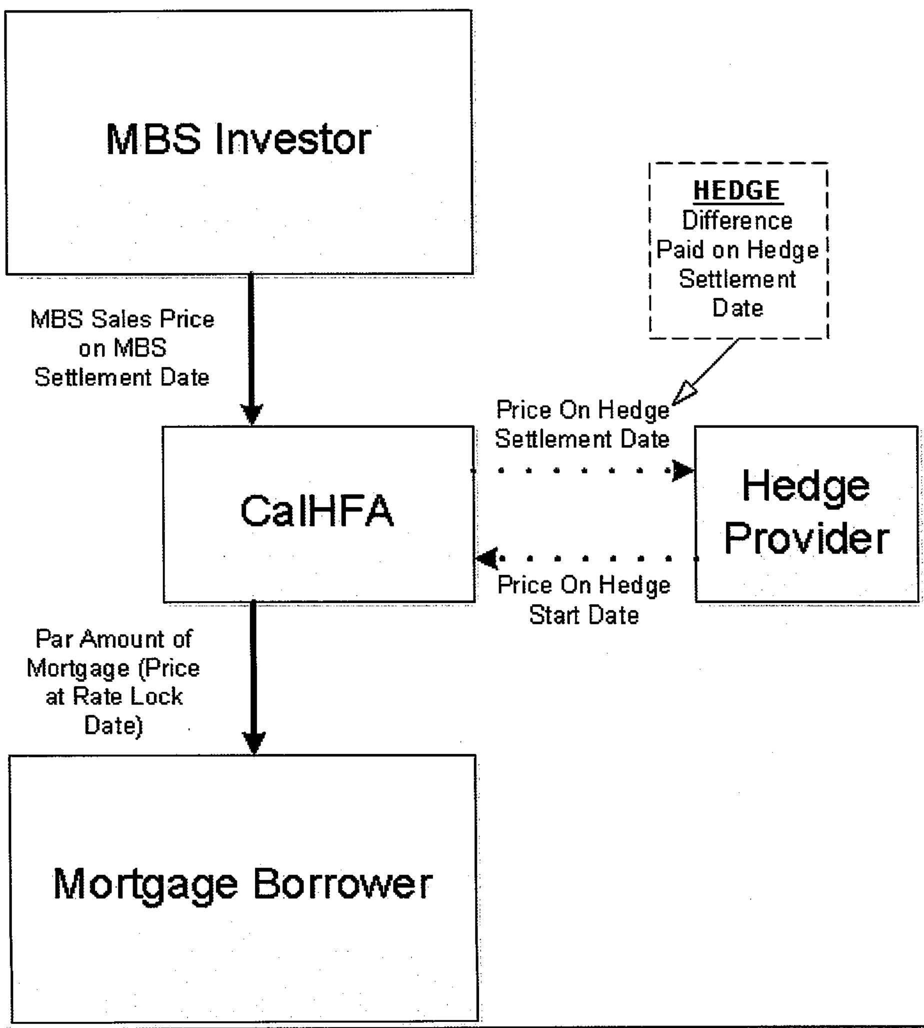
Loan Size Changes



- Size Risk - hedge amount does not match loan amount
- CalHFA takes interest rate risk on unmatched amount, but in opposite directions
- If hedge is too big, there is no loan gain offsetting hedge payment if rates decrease
- If hedge is too small, a rise in interest rates may cause losses on the MBS sale
- Staff will continually monitor hedging levels to ensure compliance with Policy and limit size risks

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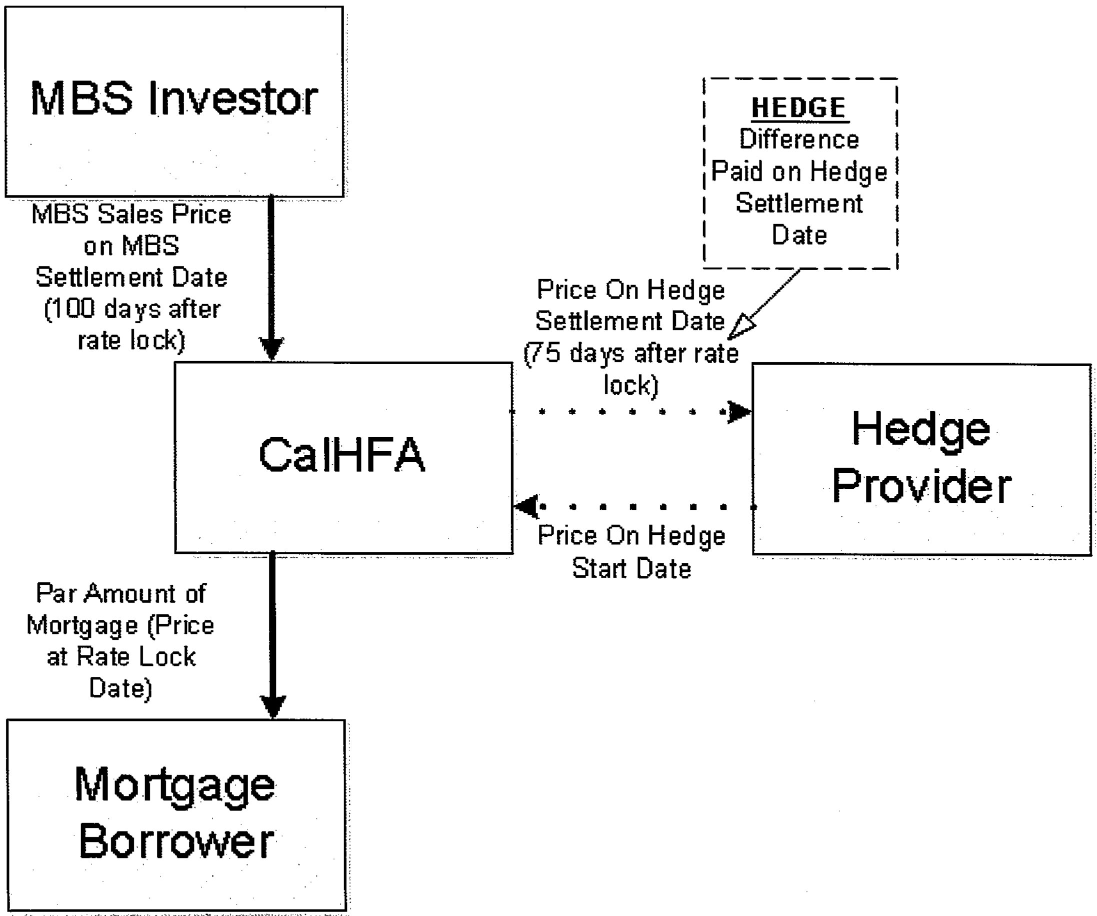
Rate Lock Duration



- Timing Risk - hedge is shorter or longer than rate lock
- CalHFA takes interest rate risk during periods of timing mismatch
- Loan programs will be designed with controls on duration of rate locks

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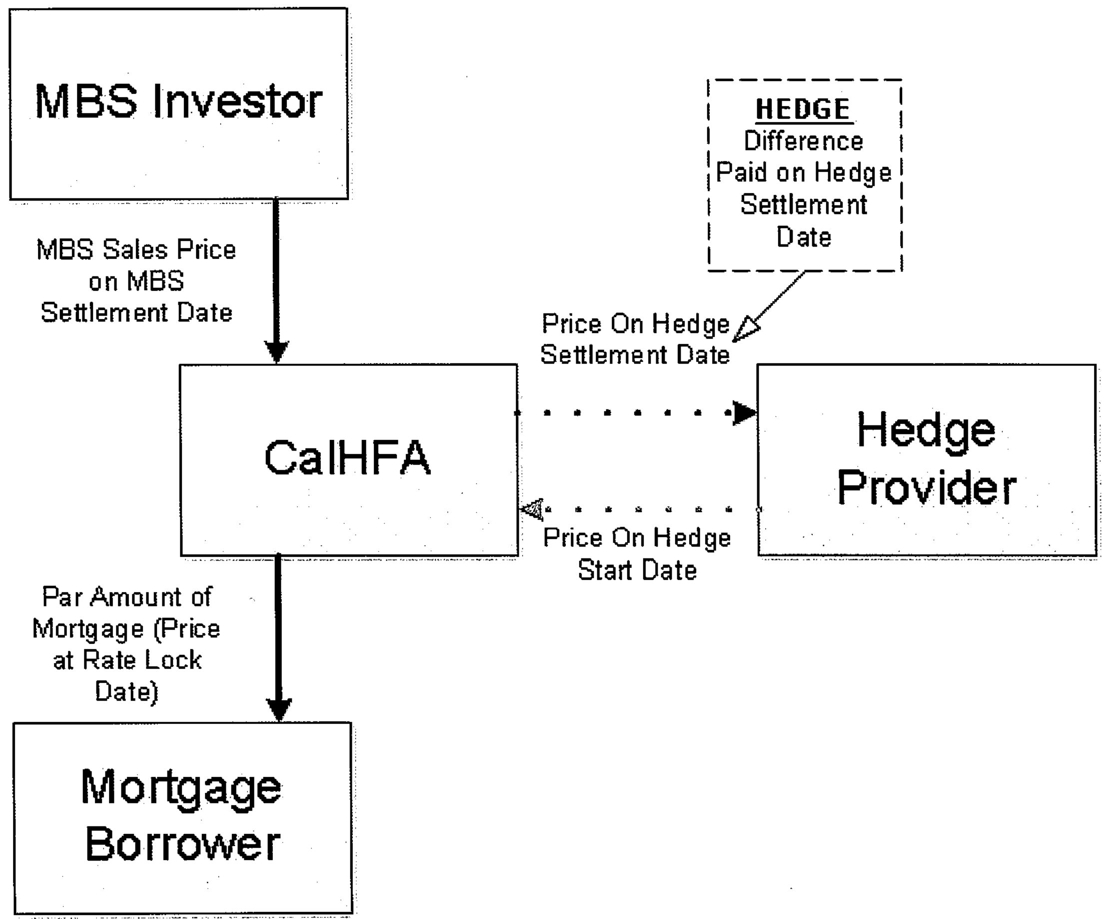
Ensure Hedge Effectiveness



- Basis Risk - hedge does not effectively offset interest rate risk due to difference in indexes
- Basis risk is a concern if CalHFA is hedging loan commitments under a fixed-rate bond program
- Single-family TBA MBS sale program should have no basis risk

Other Risks Considered

- Before entering into any hedge, the following will be considered:
  - Administrative burden of managing hedge
  - Rating agency impact (worst case is usually assumed)
  - Ability to value, replace, and terminate hedge

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Maximum Risk

- CalHFA will have sufficient capacity to terminate all hedges at market rates
- Short-term nature of hedges limit risk
- Cumulative losses from TBA hedging program shall not exceed savings from running the program in-house
- Multifamily hedging program designed with only up-front costs without ongoing costs

Hedge Reporting

- CalHFA will regularly report on its hedging activities to the following entities:
  - Board of Directors
  - Rating Agencies
  - Investors (through disclosure documents)

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Questions

If any further questions arise, please contact:

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