

California Housing Loan Insurance Fund

*Financial Statements for the
Years Ended December 31, 2004 and 2003
and Independent Auditors' Report*



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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
California Housing Finance Agency
Sacramento, California

We have audited the accompanying balance sheets of the California Housing Loan Insurance Fund (the "Fund"), which is administered by the California Housing Finance Agency (the "Agency"), a component unit of the State of California, as of December 31, 2004 and 2003, and the related statements of revenues, expenses and changes in fund equity, and of cash flows for the year then ended. These financial statements are the responsibility of the management of the Agency. Our responsibility is to express an opinion on these general purpose financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Fund as of December 31, 2004 and 2003, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Agency's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

April 29, 2005

CALIFORNIA HOUSING LOAN INSURANCE FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

Introduction – The California Housing Finance Agency

The California Housing Finance Agency (the “Agency”) was created in 1975 by an act of the California Legislature and commenced operations in 1976. The Agency is a component unit of the State of California (the “State”) and is included in the State’s Comprehensive Annual Financial Report. The Agency is authorized to administer the activities of the California Housing Loan Insurance Fund (the “Fund”), the California Housing Finance Fund (the “CHFF”) and two State general obligation bond funds. The following Management Discussion and Analysis applies only to the activities of the California Housing Loan Insurance Fund and should be read in conjunction with the Fund’s financial statements and the notes to the financial statements. The Agency is entirely self-funded and does not draw upon the general taxing authority of the State.

The Agency is authorized to use the Fund’s assets as at-risk capital in support of mortgage insurance programs which finance the acquisition, new construction or rehabilitation of residential structures in California. The Fund insures loans made by the Agency; loans made by lenders for securitization by the Federal National Mortgage Association (the “FNMA”) and Federal Home Loan Mortgage Corporation (the “FHLMC”); and loans made by localities, non-profit agencies and the California State Teachers’ Retirement System. In conducting business the Agency is authorized to reinsure any risk undertaken by the Fund.

While the Fund is subject to the same statutory requirements as private mortgage insurance companies in respect to the maintenance of policyholders’ surpluses, the Fund is exempt from regulatory control by the State Department of Insurance. The claims-paying ability of the Fund has been assigned a rating of A+ by Standard & Poor’s.

Underwriting, acquisition and issuance expenses are charged directly to the Fund as well as loss and loss adjustment expenses. Certain administrative and operating expenses, including office space, business services and supplies, legal services, accounting services, information technology support and human resource support services, are provided by the Agency and indirectly charged to the Fund.

Financial Highlights 2004 – 2003

- The Fund drew \$8.7 million of the \$85 million allocated to this purpose from the voter approved Proposition 46, *Housing and Emergency Shelter Trust Fund Act of 2002* (“Prop 46”). These funds are invested and available to be utilized to pay claims as needed.
- Insurance in force has decreased by \$69 million, or 8%, to \$797 million as of December 31, 2004. This decrease in insured loans is primarily due to the number of policy cancellations from the prepayment of the underlying loans as borrowers took advantage of historic low mortgage rates during the year to refinance their homes.
- New insurance written was \$355 million during fiscal year 2004 compared to \$341 million during fiscal year 2003. The \$14 million increase is primarily a result of a continued emphasis on the Agency’s programs.

- Continuing the trend since fiscal year 2001 and largely due to the rapid price appreciation of homes in California, insurance claims activity remained at very low levels. Insurance claim payments were \$58,400 and \$22,000 in fiscal year 2004 and 2003, respectively.
- This is the first full year of operations of our reinsurance treaty and administrative services agreement with Genworth Financial (“Genworth”), previously known as GE Mortgage Insurance Corporation (“GEMICO”). This insurance treaty cedes to Genworth a 75% quota share of the insurance risk and 64.5% of the premium collected for most loans insured by the Fund.
- Operating income decreased \$3.7 million or 96% to \$168,000 during fiscal year 2004 compared to operating income of \$3.9 million during fiscal year 2003, however, the Fund remains financially strong and has fund equity of \$55.9 million. Most of the reduction in operating income is a result of the decrease of earned premiums due to insurance cancellations from prepayments and the decrease in insurance in force.

Fiscal Year 2004 Compared to Fiscal Year 2003

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of December 31, 2004 and December 31, 2003 and the change from year to year (dollars in thousands):

	<u>2004</u>	<u>2003</u>	<u>Change</u>
Assets			
Cash, cash equivalents and investments	\$ 55,583	\$ 48,648	\$ 6,935
Other Assets	<u>2,634</u>	<u>1,913</u>	<u>721</u>
TOTAL ASSETS	<u>\$ 58,217</u>	<u>\$ 50,561</u>	<u>\$ 7,656</u>
Liabilities and Fund Equity			
Liabilities:			
Unpaid losses and loss adjustment expenses	320	810	(490)
Unearned premiums	923	1,306	(383)
Accounts payable and other liabilities	<u>1,059</u>	<u>1,408</u>	<u>(349)</u>
Total liabilities	2,302	3,524	(1,222)
Fund Equity:			
Invested in capital assets	9	13	(4)
Restricted by statute	<u>55,906</u>	<u>47,024</u>	<u>8,882</u>
Total fund equity	<u>55,915</u>	<u>47,037</u>	<u>8,878</u>
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 58,217</u>	<u>\$ 50,561</u>	<u>\$ 7,656</u>

Assets— Total assets of the Fund were \$58.2 million as of December 31, 2004, an increase of \$7.6 million or 15% from December 31, 2003. Of the Fund’s assets, more than 96% are represented by cash and investments. The Fund does not have a significant investment in capital assets.

Cash and investments were \$55.6 million as of December 31, 2004, an increase of \$7 million from December 31, 2003. The increase is primarily related to the deposit of \$8.7 million of Proposition 46 funds to be utilized by the Fund to pay claims. The Agency invests the Fund’s cash in the State’s Surplus Money Investment Fund (“SMIF”). SMIF provides the Fund a variable rate of return and complete

liquidity. Cash invested in SMIF is deposited within the State's Centralized Treasury System and managed by the State Treasurer.

Other assets were \$2.6 million as of December 31, 2004, an increase of \$721,000 from December 31, 2003. The increase is primarily in the amount which was due from the California Housing Finance Fund. As of December 31, 2004, this amount due was \$1.2 million, an increase of \$945,000 from December 31, 2003. This increase was mainly comprised of the litigation expense reimbursement due from the Agency.

Liabilities—The Fund's liabilities were \$2.3 million as of December 31, 2004, a decrease of \$1.2 million or 35% from December 31, 2003.

Unpaid losses and loss adjustment expenses were \$320,000 as of December 31, 2004, a decrease of \$490,000 from December 31, 2003. The decrease in the loss reserve is the result of the Agency entering into a reinsurance contract with Genworth under which the level of reinsurance has been increased over the prior contract resulting in a reduction in required reserves. Genworth assumes 75% of the risk on the loans under reinsurance which represent 98% of the insured loans at December 31, 2004. As of December 31, 2004, 96 insured loans with balances aggregating \$12.7 million were either reported as delinquent by the lender or, delinquent but not reported, while 147 insured loans with balances aggregating \$19.4 million were reported or delinquent and not reported by lenders as of December 31, 2003.

Unearned premiums were \$923,000 as of December 31, 2004, a decrease of \$382,000 from December 31, 2003. The decrease in unearned premiums is the continuation of an expected trend due to a change in premium collection practices. Beginning in 1996, management adopted the mortgage insurance industry norm of collecting monthly premium payments in arrears for newly established loan insurance products as compared to past practices of collecting annual premiums in advance. As a result, each year a greater percentage of insured loans require monthly premium payments, which are earned when received, rather than annual payments, which are received in advance and deferred and earned over a one-year period. During the fiscal year ending December 31, 2004 the Fund experienced high levels of prepayments of its older loan portfolio, which also contributed to the decrease in unearned premiums.

Accounts payable and other liabilities were \$1.1 million as of December 31, 2004, a decrease of \$349,000 from December 31, 2003. This decrease is largely attributable to amounts paid in 2004 for legal fees incurred in 2003.

Fund Equity—All of the Fund's equity is restricted or invested in capital assets. The Fund's equity is restricted pursuant to the Agency's enabling legislation. Total equity of the Fund grew by \$8.9 million as a result of a deposit of \$8.7 million from Prop 46 monies.

Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended December 31, 2004 and December 31, 2003 and the change from year to year (dollars in thousands):

	<u>2004</u>	<u>2003</u>	<u>Change</u>
OPERATING REVENUES			
Premiums earned	\$ 5,926	\$ 9,205	\$ (3,279)
Investment income	872	795	77
Other revenues	<u>13</u>	<u>372</u>	<u>(359)</u>
Total operating revenues	<u>\$ 6,811</u>	<u>\$ 10,372</u>	<u>\$ (3,561)</u>
OPERATING EXPENSES			
Loss and loss adjustment expenses	(450)	(803)	353
Operating expenses	7,089	7,688	(599)
Other (benefits) / expenses	<u>4</u>	<u>(417)</u>	<u>421</u>
Total operating expenses	<u>6,643</u>	<u>6,468</u>	<u>175</u>
Operating income	<u>\$ 168</u>	<u>\$ 3,904</u>	<u>\$ (3,736)</u>

Operating Revenues—Operating revenues were \$6.8 million during fiscal year 2004 compared to \$10.4 million during fiscal year 2003, a decrease of \$3.6 million or 34%.

Premiums earned in fiscal year 2004 decreased by \$3.3 million, or 36%, compared to premiums earned in fiscal year 2003. The decrease in premiums earned corresponds with the decrease in insurance in force. Insurance in force was \$797 million and \$866 million in fiscal years 2004 and 2003, respectively.

Investment income increased \$76,741 to \$871,838 in fiscal year 2004 from \$795,097 in fiscal year 2003. This increase was due to the increase in the investment portfolio. Starting in 2004, SMIF interest earnings were paid quarterly rather than semi-annually as in the past. SMIF interest rates for the past two years are shown in the following table:

<u>Interest Payment Periods</u>	<u>Fiscal Year 2004</u>	<u>Interest Payment Periods</u>	<u>Fiscal Year 2003</u>
January - March	1.467 %	January - June	1.859 %
April - June	1.441 %	July - December	1.590 %
July - September	1.665 %		
October - December	1.995 %		

Operating Expenses—Total operating expenses were \$6.6 million during fiscal year 2004 compared to \$6.4 million during fiscal year 2003, an increase of \$175,000 or 3%.

Loss and loss adjustment expenses increased by \$353,324. The increase is attributable to a reduction in delinquent loans.

The Fund's operating expenses were \$7.1 million during fiscal year 2004 compared to \$7.7 during fiscal year 2003, a decrease of \$599,000 or 8%. The decrease is primarily attributable to the decrease in premiums ceded.

Other expenses in fiscal year 2004 increased by \$421,000 when compared to other expenses incurred in fiscal year 2003. The decrease is largely attributable to a transfer to the California Housing Finance Fund of the mortgage loan portfolio in 2003 and the reversal of the allowance for loan losses associated with that portfolio.

Operating Income—Operating income for fiscal year 2004 was \$168,000 compared to \$3.9 million in fiscal year 2003, a decrease of \$3.7 million or 96%. The reduction in operating income is a result of the decrease of earned premiums due to insurance cancellations from prepayments and the decrease in insurance in force.

Fiscal Year 2003 Compared to Fiscal Year 2002

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of December 31, 2003 and December 31, 2002 and the change from year to year (dollars in thousands):

	<u>2003</u>	<u>2002</u>	<u>Change</u>
Assets			
Cash, cash equivalents and investments	\$ 48,648	\$ 36,666	\$ 11,982
Deposit with reinsurer	-	8,482	(8,482)
Program loans receivables net	-	4,828	(4,828)
Other Assets	<u>1,913</u>	<u>3,370</u>	<u>(1,457)</u>
TOTAL ASSETS	<u><u>\$ 50,561</u></u>	<u><u>\$ 53,346</u></u>	<u><u>\$ (2,785)</u></u>
Liabilities and Fund Equity			
Liabilities:			
Unpaid losses and loss adjustment expenses	810	1,641	(831)
Unearned premiums	1,306	1,936	(630)
Accounts payable and other liabilities	<u>1,408</u>	<u>6,636</u>	<u>(5,228)</u>
Total liabilities	3,524	10,213	(6,689)
Fund Equity:			
Invested in capital assets	13	12	1
Restricted by statute	<u>47,024</u>	<u>43,121</u>	<u>3,903</u>
Total fund equity	<u>47,037</u>	<u>43,133</u>	<u>3,904</u>
TOTAL LIABILITIES AND FUND EQUITY	<u><u>\$ 50,561</u></u>	<u><u>\$ 53,346</u></u>	<u><u>\$ (2,785)</u></u>

Assets— Total assets of the Fund were \$50.6 million as of December 31, 2003, a decrease of \$2.8 million or 5% from December 31, 2002. Of the Fund’s assets, more than 96% are represented by cash and investments. The Fund does not have a significant investment in capital assets.

Cash and investments were \$48.6 million as of December 31, 2003, an increase of \$12 million from December 31, 2002. The increase is primarily related to the return of the deposit from Hannover Ruckversicherungs-Aktiengesellschaft of \$8.5 million in January 2003 as the result of the Agency’s termination of that reinsurance agreement effective December 31, 2002. Also contributing to the increase was the positive cash flow from mortgage insurance operations. The Agency invests the Fund’s cash in the State’s Surplus Money Investment Fund (“SMIF”). SMIF provides the Fund a variable rate of return and complete liquidity. Cash invested in SMIF is deposited within the State’s Centralized Treasury System and managed by the State Treasurer.

As of November 1, 2003 all remaining outstanding loans receivable were purchased by the CHFF based on the then unpaid principal balance of the loans, which in conjunction with the increased prepayment activity resulted in a decrease in loans receivable of \$4.8 million.

Other assets were \$1.9 million as of December 31, 2003, a decrease of \$1.5 million from December 31, 2002. The decrease is primarily due to two factors: (1) at December 31, 2002 there was an accounts receivable of \$222,000 for accrued interest receivable on loans receivable, whereas, there was none at December 31, 2003 and (2) the amount due from servicers at December 31, 2002 of \$1.5 million decreased to \$562,000 at December 31, 2003, primarily as a result of a greater percentage of premiums being collected monthly as opposed to annually and increased efficiencies in the administration of the portfolio.

Liabilities— The Fund’s liabilities were \$3.5 million as of December 31, 2003, a decrease of \$6.7 million or 66% from December 31, 2002.

Unpaid losses and loss adjustment expenses were \$810,000 as of December 31, 2003, a decrease of \$831,000 from December 31, 2002. The decrease in the loss reserve is the result of the Agency entering into a reinsurance contract with Genworth (formerly known as GEMICO) under which the level of reinsurance has been increased over the prior contract resulting in a reduction in required reserves. Genworth assumes 75% of the risk on the loans under reinsurance which represent 98% of the insured loans at December 31, 2003. As of December 31, 2003, 147 insured loans with balances aggregating \$19.4 million were either reported as delinquent by the lender or, delinquent but not reported, while 146 insured loans with balances aggregating \$18.1 million were reported or delinquent and not reported by lenders as of December 31, 2002.

Unearned premiums were \$1.3 million as of December 31, 2003, a decrease of \$630,000 from December 31, 2002. The decrease in unearned premiums is the continuation of an expected trend due to a change in premium collection practices. Beginning in 1996 management adopted the mortgage insurance industry norm of collecting monthly premium payments in arrears for newly established loan insurance products as compared to past practices of collecting annual premiums in advance. As a result, each year a greater percentage of insured loans require monthly premium payments, which are earned when received, rather than annual payments which are received in advance and deferred and earned over a one year period. During the fiscal year ending December 31, 2003 the Fund experienced high levels of prepayments of its older loan portfolio which also contributed to the decrease in unearned premiums.

Accounts payable and other liabilities were \$1.4 million as of December 31, 2003, a decrease of \$5.2 million from December 31, 2002. This decrease is largely attributable to two factors: (1) management’s decision to repay the notes to Allstate Insurance Company, which resulted in a \$2.8 million decrease in notes payable and (2) management’s decision to repay the \$2.5 million loan from CHFF for the purchase of down payment assistance loans.

Fund Equity— All of the Fund’s equity is restricted or invested in capital assets. The Fund’s equity is restricted pursuant to the Agency’s enabling legislation. Total equity of the Fund grew by \$3.9 million as a result of operating income.

Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended December 31, 2003 and December 31, 2002 and the change from year to year (dollars in thousands):

	<u>2003</u>	<u>2002</u>	<u>Change</u>
OPERATING REVENUES			
Premiums earned	\$ 9,205	\$ 13,037	\$ (3,832)
Investment income	795	882	(87)
Other revenues	<u>372</u>	<u>340</u>	<u>32</u>
Total operating revenues	<u>\$ 10,372</u>	<u>\$ 14,259</u>	<u>\$ (3,887)</u>
OPERATING EXPENSES			
Loss and loss adjustment expenses	(803)	361	(1,164)
Operating expenses	7,688	4,341	3,347
Other (benefits) / expenses	<u>(417)</u>	<u>342</u>	<u>(759)</u>
Total operating expenses	<u>6,468</u>	<u>5,044</u>	<u>1,424</u>
Operating income	<u>\$ 3,904</u>	<u>\$ 9,215</u>	<u>\$ (5,311)</u>

Operating Revenues— Operating revenues were \$10.4 million during fiscal year 2003 compared to \$14.3 million during fiscal year 2002, a decrease of \$3.9 million or 27%.

Premiums earned in fiscal year 2003 decreased by \$3.8 million, or 29%, compared to premiums earned in fiscal year 2002. The decrease in premiums earned corresponds with the decrease in insurance in force. Insurance in force was \$866 million and \$1.39 billion in fiscal years 2003 and 2002 respectively.

Although the Fund's investment portfolio increased during fiscal year 2003, investment income decreased \$87,000 to \$795,000 in fiscal year 2003 from \$882,000 in fiscal year 2002. The increase in the level of the investments was not enough to offset the impact of the continuing drop in the rates earned. For the past two years, the SMIF paid interest at the rates and for the periods as shown in the following table:

<u>Interest Payment Periods</u>	<u>Fiscal Year 2003</u>	<u>Interest Payment Periods</u>	<u>Fiscal Year 2002</u>
January - June	1.859 %	January - June	2.853 %
July - December	1.590 %	July - December	2.468 %

Operating Expenses— Operating expenses were \$6.4 million during fiscal year 2003 compared to \$5.0 million during fiscal year 2002, an increase of \$1.4 million or 28%.

Loss and loss adjustment expenses decreased by \$1.2 million. The decrease is attributable to the decrease in the loss reserve as a result of the Agency entering into a reinsurance contract with Genworth in which Genworth assumes 75% of the insured risk on most loans insured by the Fund thus decreasing the Fund's exposure to claim losses.

The Fund's operating expenses were \$7.7 million during fiscal year 2003 compared to \$4.3 during fiscal year 2002, an increase of \$3.4 million or 78%. The increase is primarily attributable to the increase in

premiums ceded and administrative fees of \$5.5 million during fiscal year 2003 compared to \$2.5 million during fiscal year 2002.

Other expenses in fiscal year 2003 decreased by \$759,000 when compared to other expenses incurred in fiscal year 2002. The decrease is largely attributable to a decrease in the provision for loan losses of approximately \$655,000, which is due to the high level of prepayments in the mortgage loan portfolio during fiscal year 2003 and the purchase of the remaining loans as of November 1, 2003 by the California Housing Finance Fund.

Operating Income— Operating income for fiscal year 2003 was \$3.9 million compared to \$9.2 million in fiscal year 2002, a decrease of \$5.3 million or 58%. This decrease in income is primarily a result of the Genworth reinsurance treaty which provides for a true transfer of risk of a greater quota share of claims in exchange for a higher share of the premiums.

CALIFORNIA HOUSING LOAN INSURANCE FUND

BALANCE SHEETS

DECEMBER 31, 2004 AND 2003

ASSETS	2004	2003
CURRENT ASSETS:		
Cash and cash equivalents	\$ 32,990	\$ 64,059
Investment in Surplus Money Investment Fund (“SMIF”)	55,550,000	48,584,000
Interest receivable	281,672	384,831
Due from California Housing Finance Fund	1,256,516	311,807
Other assets	<u>782,289</u>	<u>950,854</u>
Total current assets	<u>57,903,467</u>	<u>50,295,551</u>
NONCURRENT ASSETS—Other assets	<u>313,057</u>	<u>265,313</u>
TOTAL ASSETS	<u>\$ 58,216,524</u>	<u>\$ 50,560,864</u>
LIABILITIES AND FUND EQUITY		
CURRENT LIABILITIES:		
Reserves for unpaid losses and loss adjustment expenses	\$ 320,023	\$ 809,989
Unearned premiums	815,355	1,124,250
Reinsurance Payable	266,560	303,425
Accounts payable and other liabilities	87,315	741,337
Due to California Housing Finance Fund	<u>704,752</u>	<u>362,970</u>
Total current liabilities	<u>2,194,005</u>	<u>3,341,971</u>
NONCURRENT LIABILITIES—Unearned premiums	107,518	181,114
Total liabilities	<u>2,301,523</u>	<u>3,523,085</u>
CONTINGENCIES (Note 8)		
FUND EQUITY:		
Invested in capital assets	9,339	13,389
Restricted by statute	<u>55,905,662</u>	<u>47,024,390</u>
Total fund equity	<u>55,915,001</u>	<u>47,037,779</u>
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 58,216,524</u>	<u>\$ 50,560,864</u>

See notes to financial statements.

CALIFORNIA HOUSING LOAN INSURANCE FUND

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY FISCAL YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
OPERATING REVENUES:		
Premiums earned	\$ 5,926,550	\$ 9,204,693
Investment income	871,838	795,097
Other revenues	<u>12,927</u>	<u>372,420</u>
Total operating revenues	<u>6,811,315</u>	<u>10,372,210</u>
OPERATING EXPENSES:		
Loss and loss adjustment expenses/recoveries	(450,429)	(803,753)
Operating expenses	7,089,471	7,688,441
Other benefits/expenses	<u>4,051</u>	<u>(416,816)</u>
Total operating expenses	<u>6,643,093</u>	<u>6,467,872</u>
OPERATING INCOME	168,222	3,904,338
TRANSFER FROM PROP 46 (Note 7)	8,709,000	-
FUND EQUITY—Beginning of year	<u>47,037,779</u>	<u>43,133,441</u>
FUND EQUITY—End of year	<u>\$55,915,001</u>	<u>\$47,037,779</u>

See notes to financial statements.

CALIFORNIA HOUSING LOAN INSURANCE FUND

STATEMENTS OF CASH FLOWS

FISCAL YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from customers	\$ 5,750,495	\$ 9,644,971
Payments to suppliers	(7,196,424)	(6,113,833)
Payments to employees	(672,620)	(880,190)
Internal activity—payments to other funds	(602,928)	300,398
Other receipts (payments)	(27,589)	11,096,066
	<u>(2,749,066)</u>	<u>14,047,412</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Payment on notes	-	(2,818,141)
Interest paid on notes	-	(71,516)
	<u>-</u>	<u>(2,889,657)</u>
CASH FLOWS PROVIDED BY RELATED FINANCING ACTIVITIES—Interfund transfers from Prop 46 (Note 7)		
	8,709,000	-
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of investments	4,667,000	8,557,000
Purchase of investments	(11,633,000)	(21,817,000)
Interest on investments	974,997	824,348
	<u>(5,991,003)</u>	<u>(12,435,652)</u>
DECREASE IN CASH AND CASH EQUIVALENTS		
	(31,069)	(1,277,897)
CASH AND CASH EQUIVALENTS—Beginning of year		
	<u>64,059</u>	<u>1,341,956</u>
CASH AND CASH EQUIVALENTS—End of year		
	<u>\$ 32,990</u>	<u>\$ 64,059</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES:		
Operating income	\$ 168,222	\$ 3,904,338
Adjustments to reconcile operating income to net cash (used in) provided by operating activities:		
Interest paid to Allstate	-	52,035
Interest on investments	(871,838)	(795,097)
Allowance for loan losses	-	(654,944)
Unpaid loss and loss adjustment expenses	(489,966)	(830,653)
Depreciation expense	4,051	3,795
Deferred policy acquisition expense	314,558	327,659
Changes in certain operating assets and liabilities:		
Interest receivable	-	6,726
Deposit with reinsurer	-	8,481,553
Program loans receivable	-	5,483,192
Other assets	(197,786)	890,904
Unearned premiums	(382,491)	(630,405)
Payable to reinsurer	(36,865)	283,795
Accounts payable and other liabilities	(654,023)	(368,700)
Due to California Housing Finance Fund	(602,928)	(2,106,786)
	<u>(2,749,066)</u>	<u>14,047,412</u>
Net cash (used in) provided by operating activities	<u>\$ (2,749,066)</u>	<u>\$ 14,047,412</u>

CALIFORNIA HOUSING LOAN INSURANCE FUND

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2004 AND 2003

1. AUTHORIZING LEGISLATION AND ORGANIZATION

The California Housing Loan Insurance Fund (the “Fund”) is one of two continuously appropriated funds administered by the California Housing Finance Agency (the “Agency”). The Agency was created by the Zenovich-Moscone-Chacon Housing and Home Finance Act (the “Act”), as amended, as a public instrumentality, a political subdivision and a component unit of the State of California (the “State”), and is in the State’s Annual Financial Report, and administers the activities of the Fund and the California Housing Finance Fund (the “CHFF”). These funds allow the Agency to carry out its purpose of meeting the housing needs of persons and families of low and moderate income within the State. The Agency is authorized to insure mortgage loans, and to issue bonds, notes and other obligations to fund loans to qualified borrowers for single family houses and multifamily developments. The Agency has no taxing power and is exempt from Federal income taxes and state franchise taxes.

The accompanying financial statements are the statements of the Fund and do not include the financial position or the results of operations of the CHFF. As of June 30, 2004 the CHFF had total assets of \$9,681,427 and fund equity of \$1,119,300 (not covered by this Independent Auditors’ Report).

The Agency is also authorized to use the Fund to provide mortgage insurance for loans made by the Agency and others which finance the acquisition, new construction or rehabilitation of residential structures in California. Total risk in-force was \$384,482,000 and \$390,810,000 at December 31, 2004 and 2003, respectively. Over 95% of the insured first mortgage loans outstanding at December 31, 2004 have loan to value ratios, measured as of the funding date of the loan, equal to or greater than 90%.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Accounting—The Fund is accounted for as an enterprise fund. Accordingly the accompanying financial statements have been prepared using the accrual method of accounting and on the basis of accounting principles generally accepted in the United States of America (hereinafter referred to as “Generally Accepted Accounting Principles”) which differ from statutory accounting practices followed by insurance companies in reporting to insurance regulatory authorities.

Accounting and Reporting Standards—The Agency follows the *Standards of Governmental Accounting and Financial Reporting*, as promulgated by the *Governmental Accounting Standards Board* (“GASB”). The Agency has adopted the option under GASB No. 20 which allows the Agency to apply all GASB pronouncements and only *Financial Accounting Standards Board* (“FASB”) pronouncements which date prior to November 30, 1989.

Use of Estimates—The preparation of financial statements in conformity with Generally Accepted Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Cash and cash equivalents—The Agency considers cash on hand and cash on deposit with the State Controller’s office other than the investment in the State’s Surplus Money Investment Fund (the “SMIF”) to be cash and cash equivalents.

Investments—The Agency invests the Fund’s cash in the SMIF, which represents a portion of the State’s Pooled Money Investment account (“PMIA”). These PMIA funds are on deposit within the State’s Centralized Treasury System and are managed in compliance with the California Government Code, according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. Investments in SMIF are recorded at fair value and are not required to be categorized under GASB Statement No. 3. The office of the State Treasurer of California issues a Pooled Money Investment Board Report with information on the PMIA’s portfolio composition. A copy of that report may be obtained from the Office of the State Treasurer, 915 Capitol Mall, Room 106, Sacramento, CA 95814 or via the Internet at www.treasurer.ca.gov.

Deferred Policy Acquisition Costs—The Fund defers certain costs related to the acquisition of new insurance policies and amortizes these costs over the expected life of the policies. These costs are associated with the acquisition, underwriting and processing of new policies. Deferred Policy Acquisition Costs were \$558,408 and \$469,721 for the years ended December 31, 2004 and 2003, respectively, and are included as part of Other Assets on the Balance Sheets.

Reserves for Unpaid Losses and Loss Adjustment Expenses—The Fund establishes reserves for losses and loss adjustment expenses, to recognize the estimated liability for potential losses and related loss expenses in connection with borrower default on mortgage payments. The liability for unpaid losses and loss adjustment expenses resulting from mortgage insurance is an estimate based upon the unpaid delinquent balance on mortgage loans reported by lenders as of the close of the accounting period, estimates of incurred but not reported (“IBNR”) claims and historical and expected frequency and loss severity information.

There is a high level of uncertainty inherent in the evaluation of the required loss and loss adjustment expense reserves. Management has selected frequency of claims paid and severity loss ratios that it believes are reasonable and reflective of anticipated ultimate experience. The ultimate costs of claims are dependent upon future events, the outcomes of which are affected by many factors. The Agency’s claim-reserving procedures and settlement practices, economic inflation, court rulings, real estate market conditions and many other economic, scientific, legal, political, and social factors all can have significant effects on the ultimate cost of claims.

Changes in operations and management practices may also cause actual developments to vary from past experience. Since the emergence and disposition of claims are subject to uncertainties, the net amounts that will ultimately be paid to settle the liability may vary significantly from the estimated amounts provided for in the accompanying financial statements. Any adjustments that may be material to reserves are reflected in the operating results of the periods in which they are made.

Fund Equity—Fund equity is classified as invested in Capital Assets or Restricted Equity. Invested in Capital Assets represents investments in office equipment and furniture net of depreciation. Restricted Equity represents equity that is restricted pursuant to the Agency’s enabling legislation.

Operating Revenues and Expenses—The Fund’s primary operating revenue is derived from premiums earned on private mortgage insurance written. The primary expenses are the expenses associated with the underwriting, acquisition, issuance, administration and the reinsurance of private mortgage insurance products and policies.

Recognition of Premium Income—Primary mortgage insurance policies are contracts that are generally non-cancelable by the insurer, and provide payment of premiums on a monthly, annual or single basis. Premiums written on a monthly basis are earned as coverage is provided. Premiums written on an annual basis are deferred as unearned premiums and amortized on a monthly pro rata basis over the year of coverage. Primary mortgage insurance premiums written on policies covering more than one year are referred to as single premiums. A portion of single premiums is recognized immediately in earnings, and

the remaining portion is deferred as unearned premiums and amortized over the expected life of the policy.

Reinsurance—Effective March 1, 2003, the Agency entered into a reinsurance treaty and administrative services agreement with General Electric Mortgage Insurance Corporation (“Genworth”). This agreement cedes to Genworth a 75% quota share of the insurance risk for most loans insured by the Fund and provides for certain administrative services to be performed by Genworth. The Fund uses reinsurance to reduce net risk in force and optimize capital allocation.

Recent Accounting Pronouncements—In March 2003, GASB issued Statement of Governmental Accounting Standards (“SGAS”) No. 40, *Deposit and Investment Risk Disclosures, an amendment of SGAS No. 3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. SGAS No. 40 requires disclosures regarding additional risks to which governments may be exposed. The Agency plans to adopt the provisions of SGAS No. 40 for the Fund effective January 1, 2005. SGAS No. 40 requires disclosure of information covering investment credit risk disclosures; interest rate disclosures that include investment maturity information; interest rate sensitivity for investments that are highly sensitive to changes in interest rates; and foreign exchange exposures that would indicate the foreign investment’s denomination. Management does not expect that the adoption of this statement will have a significant impact on its financial position or results of operations.

In December 2004, GASB issued SGAS No. 46, *Net Assets restricted by Enabling Legislation*, an amendment of SGAS No. 34, effective for periods beginning after June 15, 2005. SGAS No. 46 clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government—such as citizens, public interest groups, or the judiciary—can compel a government to honor. The Statement states that the legal enforceability of an enabling legislation restriction should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if a government has other cause for reconsideration. Management of the Agency has not completed the process of evaluating the impact that will result from adopting SGAS No. 46.

3. RESERVES FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

Changes in the reserves for unpaid losses and loss adjustment expenses for the years ended December 31, 2004 and 2003 are summarized as follows:

	2004	2003
Beginning of year balance	\$ <u>809,989</u>	\$ <u>1,640,643</u>
Incurred/recovered related to:		
Current year	457,437	1,724,971
Prior years	<u>(1,583,746)</u>	<u>(1,215,086)</u>
Total incurred	<u>(1,126,309)</u>	<u>509,885</u>
Paid related to:		
Current year		
Prior years	<u>58,414</u>	<u>22,257</u>
Total paid	<u>58,414</u>	<u>22,257</u>
Risk ceded to Genworth:		
Current year	(623,525)	(1,318,282)
Prior years	<u>1,318,282</u>	<u> </u>
Total ceded	<u>694,757</u>	<u>(1,318,282)</u>
End of year balance	<u>\$ 320,023</u>	<u>\$ 809,989</u>

Reserves for loss and loss adjustment expenses incurred for the current year relate to delinquent loans at December 31, 2004 and 2003 and represent the estimated ultimate amount of losses to be paid on such delinquencies. Current year losses incurred have increased from 2002 as a result of a decline in overall economic conditions, an increase in the unpaid principal balance of the underlying mortgage loan portfolio and a change in the delinquency status of the underlying mortgage loan portfolio. The credits included in reserves for losses and loss adjustment expenses incurred related to insured events of prior years represent the favorable development of reserves as a result of actual claim rates and claim amounts being lower than those estimated when originally establishing reserves. Such estimates were based on historical experience which management believed was representative of expected future losses at the time of estimation. As a result of the extended period of time that may exist between the report of a delinquency and claim payment thereon, significant uncertainty and variation exist with respect to the ultimate amount to be paid because economic conditions and real estate markets will change.

4. REINSURANCE

Effective March 1, 2003, the fund entered into a 75% quota-share reinsurance agreement with Genworth to reinsure 98% of the Funds portfolio. Under the terms of this agreement, the reinsurer will indemnify the Fund for 75% of all losses paid on the insured loans to which the Fund cedes 64.5% of the related premiums. The Agency's reinsurance agreement typically provides for a recovery of a proportionate level of claim expenses from the reinsurer. The Fund remains liable to its policyholders if the reinsurer is unable to satisfy their obligations under the reinsurance agreement. As of December 31, 2004 the amount ceded to Genworth was \$3,633,888.

5. ARRANGEMENTS WITH THE CALIFORNIA HOUSING FINANCE FUND

Certain of the administrative and operating expenses charged to the Fund are provided by the Agency. These expenses, initially paid from the CHFF, include office space, business services, legal services, accounting services, information systems support and human resource support services. The Fund is

charged quarterly for these expenses. Amounts payable to the CHFF were \$704,752 and \$362,970 at December 31, 2004 and 2003, respectively. The increase in the amount payable at December 31, 2004 was due to a change in the reimbursement procedures. For the years ended December 31, 2004 and 2003, total expenses allocated to the Fund by the Agency were \$1,432,294 and \$1,336,649 respectively. For the years ending December 31, 2004 and 2003, management determined that CHFF should participate in certain legal and consulting expenses originally paid by the Fund. The amount due to the Fund from the CHFF for these expenses was \$1,256,516 and \$311,807 at December 31, 2004 and 2003 respectively and is included in the Due from California Housing Finance Fund.

The Agency Board of Directors approved Resolution 03-19 on March 20, 2003 authorizing the Agency to utilize the resources of CHFF to support the mortgage guaranty insurance programs of the Agency in the following two ways: 1) the Executive Director of the Agency is authorized to create one or more supplementary reserve accounts within the Supplementary Bond Security Account of CHFF to indemnify the Mortgage Insurance fund for losses incurred or to pay claims against the Mortgage Insurance Fund in connection with loans financed by the Agency, and 2) the Executive Director of the Agency may establish an inter-fund credit agreement by which the Fund may borrow such sums from CHFF as may be required to maintain the claims paying rating of any credit rating service.

Subsequently, the Agency Executive Director established an inter-fund credit agreement in the amount of \$100,000,000 in which the Fund may borrow from CHFF as needed for the purpose of paying claims arising out of policies of mortgage guarantee insurance and costs and expenses related to the payment of such claims. Interest rates and repayment terms are determined upon receipt of a request to draw on this credit facility. The Fund had not requested a draw on this credit through December 31, 2004.

6. PENSION PLAN

The Fund contributes to the Public Employees' Retirement Fund ("PERF") as part of the State of California, the primary government. The PERF is a cost-sharing multiple-employer defined benefit pension plan administered by the California Public Employment Retirement System ("CalPERS"). CalPERS provides retirement, death, disability and post retirement health care benefits to members as established by state statute. CalPERS issues a publicly available Comprehensive Annual Financial Report ("CAFR") that includes financial statements and required supplementary information for the Public Employees' Retirement Fund. A copy of that report may be obtained from CalPERS, Central Supply, and P.O. Box 942175, Sacramento, CA 95229-2715 or via the internet at www.calpers.ca.gov.

For the CalPERS fiscal years ended June 30, 2004 and 2003 the employer contribution rates were 10.265% to 14.843% and 2.813% to 7.413%, respectively. For the CalPERS fiscal year beginning July 1, 2004, which covers the period July 1, to December 31, 2004, the employer contribution rates were 13.216 % to 17.022%.

The Fund's contributions to the PERF for the years ended December 31, 2004, 2003 and 2002 were \$109,919, \$87,784 and \$29,358, respectively, equal to the required contributions for each fiscal year.

Required contributions are determined by actuarial valuation using the individual entry age normal cost method. The most recent actuarial valuation available is as of June 30, 2002, which actuarial assumptions included (a) 8.25% investment rate of return compounded annually, (b) projected salary increases that vary by duration of service, and (c) overall payroll growth factor of 3.75% annually. Both (a) and (c) included an inflation component of 3.5% and a .25% per annum productivity increase assumption. The amortization method is based on a level percentage of payroll closed. The remaining amortization at June 30, 2002 was 13 to 30 years.

The most recent actuarial valuation of the PERF indicated that there was an unfunded actuarial accrued liability. The amount of the under funded liability applicable to each agency or department cannot be

determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due is presented in the June 30, 2004 CalPERS CAFR.

7. TRANSFER HOUSING AND EMERGENCY SHELTER TRUST FUND ACT OF 2002

The *Housing and Emergency Shelter Trust Fund Act of 2002* (“Prop 46”) is a \$2.1 billion dollar bond measure that was passed by the voters of California in November 2002. The bond provides monies to help fund the construction, rehabilitation and preservation of affordable rental housing, emergency shelters and homeless facilities, as well as funds that can be used to provide down payment assistance to low and moderate income first-time homebuyers. As such, the Fund drew \$8.7 million of the \$85 million allocated towards the assistance in developing low income housing from Prop 46. These funds are invested and available to be utilized to pay claims as needed.

8. CONTINGENCIES

Certain lawsuits and claims arising in the ordinary course of business have been filed or are pending against the Agency. Based upon information available to the Agency, its review of such lawsuits and claims and consultation with counsel, the Agency believes the liability relating to these actions, if any, would not have a material adverse effect on the Fund’s financial statements.

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