# California Housing Loan Insurance Fund

Financial Statements and Supplementary Information
for the Years Ended December 31, 2010 and 2009,
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, 2010 and 2009, and the related statements of revenues, expenses, and changes in fund equity, and cash flows for the years then ended. The accompanying financial statements are the statements of the Fund and do not include the financial position or the results of the operations of the Agency. These financial statements are the responsibility of the management of the Agency. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide 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, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements for the year ended December 31, 2010 have been prepared assuming that the Fund will continue as a going concern. As discussed in Note 2 to the financial statements, the Fund is experiencing difficulty in generating sufficient cash flow to meet its obligations and sustain its operations, which raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also discussed in Note 2 to the financial statements. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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.

May 5, 2011

Deloitte + Touche LLP

## CALIFORNIA HOUSING LOAN INSURANCE FUND

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS YEARS ENDED DECEMBER 31, 2010 AND 2009

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, nonprofit 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 with respect to the maintenance of policyholders' surplus, 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 Caa3 by Moody's Investors Service.

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 RESULTS 2010 – 2009

- Insurance in force decreased by $518 million, or 22%, to $2.3 billion as of December 31, 2010, compared to $2.8 billion as of December 31, 2009. The Fund ceased committing to insure new loans in September 2009.

- The Fund had an operating loss of $24.9 million for 2010. Net operating results of the Fund improved by approximately $29 million in 2010 compared to the operating loss of $54 million in 2009. This was primarily due to a decrease in losses incurred during 2010 as the rate of growth of delinquencies declined and the reserve for loan losses declined during 2010. The Fund has negative fund equity balance of $24.7 million at December 31, 2010, compared to a positive fund equity balance of $194 thousand at December 31, 2009.

- Home mortgage delinquencies declined during the year, the delinquency ratio for the insured portfolio decreased to 20.6% in December 2010 or $493 million, down from 22% or $638 million in December 2009. Gross insurance claim payments were $167.3 million and $94.3 million in 2010 and 2009, respectively, before reinsurance.

- The Fund's reserve for loan losses decreased by $13.4 million in 2010 to $49.6 million as a result of the Fund's decreased number of delinquencies outstanding. The Agency continues to monitor delinquencies closely and is proactive in its attempts to mitigate losses.

- The Fund continued the 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. The treaty was amended for loans insured on or after May 1, 2008 to 67% of premium collected and amended again on April 1, 2009 to 69% of premium collected on loans insured on or after that date.

- In February 2010, Moody's Investors Service reaffirmed the current rating of Baa2 for Genworth and changed the outlook to negative. In September 2010, Standard and Poor's Ratings Services ("S&P") affirmed the counterparty credit and financial strength ratings on Genworth at "BBB-".

- In September 2010, S&P lowered the Fund's rating to "CC" from "CCC-" and withdrew the ratings on the Fund at the Agency's request. The rating was lowered due to continued elevated level of notices of default and erosion of capital.

- In December 2010, Moody's lowered the Fund's rating to "Caa3" from "B2". The rating was lowered based on a sharp decline in performance of the insured portfolio, a decline in the fund capital position due to an increase in insurance claims paid, and projections that future claims may lead to shortfalls in funds available for claim payments in the future.

- Based on its projections, management of the Fund believes that the Fund will not be able to meet all of its obligations as they become due in 2011. The Agency has forecasted it may intermittently deplete its available funds for paying claims and expenses during the third quarter of 2011 (see Note 2) and continues to remain dependent upon the ability of the Fund's reinsurer to pay its share of the claims (see Note 5).

**2010 COMPARED TO 2009**

**CONDENSED BALANCE SHEETS**

The following table presents condensed balance sheets for the Fund as of December 31, 2010 and 2009, and the change from year to year (dollars in thousands):

| | 2010 | 2009 | Change |
|---|---|---|---|
| **ASSETS** | | | |
| Cash, cash equivalents, and investments | $ 28,081 | $ 65,290 | $ (37,209) |
| Other assets | 1,019 | 1,490 | (471) |
| TOTAL | $ 29,100 | $ 66,780 | $ (37,680) |
| **LIABILITIES AND FUND EQUITY (DEFICIT)** | | | |
| LIABILITIES: | | | |
| Unpaid losses and loss adjustment expenses | $ 49,596 | $ 62,962 | $ (13,366) |
| Unearned premiums | 175 | 244 | (69) |
| Accounts payable and other liabilities | 4,065 | 3,380 | 685 |
| Total liabilities | 53,836 | 66,586 | (12,750) |
| FUND EQUITY (DEFICIT): | | | |
| Invested in capital assets | 28 | 33 | (5) |
| Restricted | | 161 | (161) |
| Unrestricted | (24,764) | | (24,764) |
| Total fund equity (deficit) | (24,736) | 194 | (24,930) |
| TOTAL | $ 29,100 | $ 66,780 | $ (37,680) |

**Assets** — Total assets of the Fund were $29.1 million as of December 31, 2010, a decrease of $37.7 million or 56% from December 31, 2009. 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, cash equivalents, and investments were $28.1 million as of December 31, 2010, a decrease of $37.2 million from December 31, 2009. The decrease is primarily due to an increase in claim payments. 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 $1.0 million as of December 31, 2010, a decrease of $0.5 million or 32% from December 31, 2009. The decrease is the result of a decline in interest receivable from decreased earning rates in the State's SMIF and decrease in reinsurance receivable as a result of higher number of claims being paid.

**Liabilities** — The Fund's liabilities were $53.8 million as of December 31, 2010, a decrease of $12.8 million or 19% from December 31, 2009.

The reserve for unpaid losses and loss adjustment expenses was $49.6 million as of December 31, 2010, a decrease of $13.4 million from December 31, 2009. The decrease in the loss reserve is the result of the Fund's lower loss reserves required to cover potential losses. As of December 31, 2010, 1927 insured loans with balances aggregating $542 million were either reported as delinquent by the lender or assumed delinquent but not reported. As of December 31, 2009, 2505 insured loans with balances aggregating $661 million were either reported as delinquent by the lender or assumed delinquent but not reported.

Unearned premiums were $175,000 as of December 31, 2010, a decrease of $69,000 from December 31, 2009. The decrease was due to policy adjustments between the servicer and reinsurer. The expected trend of this account is to decrease over time 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.

Accounts payable and other liabilities were $4.1 million as of December 31, 2010, an increase of $0.7 million from December 31, 2009. This increase is largely attributable to amounts owed to the reinsurer for claim payments.

**Fund Equity** — The Fund's equity is classified as restricted, unrestricted or invested in capital assets. Total equity of the Fund decreased by $24.9 million as a result of the current year operating loss.

## CONDENSED STATEMENTS OF REVENUES AND EXPENSES

The following table presents condensed statements of revenues and expenses for the Fund for the years ended December 31, 2010 and 2009, and the change from year to year (dollars in thousands):

| | 2010 | 2009 | Change |
|---|---|---|---|
| OPERATING REVENUES: | | | |
| Premiums earned | $ 16,502 | $ 20,894 | $ (4,392) |
| Investment income | 255 | 924 | (669) |
| Other revenues | 8 | 2 | 6 |
| Total operating revenues | 16,765 | 21,820 | (5,055) |
| OPERATING EXPENSES: | | | |
| Loss and loss adjustment expenses | 29,727 | 60,632 | (30,905) |
| Operating expenses | 11,958 | 14,940 | (2,982) |
| Other expenses | 10 | 207 | (197) |
| Total operating expenses | 41,695 | 75,779 | (34,084) |
| OPERATING LOSS | $ (24,930) | $ (53,959) | $ 29,029 |

**Operating Revenues** — Operating revenues were $16.8 million during 2010 compared to $21.8 million during 2009, a decrease of $5.0 million or 23%.

Premiums earned in 2010 decreased by $4.4 million or 21% compared to premiums earned in 2009. The decrease in premiums earned corresponds with the decrease in insurance in force. Insurance in force were $2.3 billion and $2.8 billion as of December 31, 2010 and 2009, respectively.

Investment income decreased $669,000 to $255,000 in 2010 from $924,000 in 2009. This decrease was due to the decrease in interest rates and decrease in investment in SMIF. SMIF interest rates for the past two years are shown in the following table:

| Periods | Year 2010 | Periods | Year 2009 |
|---|---|---|---|
| January — March | 0.551% | January — March | 1.903% |
| April — June | 0.559% | April — June | 1.512% |
| July — September | 0.503% | July — September | 0.889% |
| October — December | 0.456% | October — December | 0.594% |

Other revenues increased by $6,000 to $8,000 in 2010 from $2,000 in 2009. Recoveries made on amounts owed from defendants in certain litigation increased from last year

**Operating Expenses** — Total operating expenses were $41.7 million during 2010 compared to $75.8 million during 2009, a decrease of $34.1 million or 45%.

Loss and loss adjustment expenses decreased by $30.9 million in 2010. The decrease is attributable to the decrease in required reserves to cover potential losses.

The Fund's operating expenses were $11.9 million during 2010 compared to $14.9 million during 2009, a decrease of $3.0 million or 20%. The decrease is primarily a result of lower ceded premiums to the reinsurer due to lower insurance in force and a decrease in salary expenses.

**Operating Loss** — Operating loss for 2010 was $24.9 million compared to $53.9 million loss in 2009, a decrease of $29 million. The decrease in operating loss is a result of the decrease in loss and loss adjustment expenses.

## 2009 COMPARED TO 2008

## CONDENSED BALANCE SHEETS

The following table presents condensed balance sheets for the Fund as of December 31, 2009 and 2008, and the change from year to year (dollars in thousands):

| | 2009 | 2008 | Change |
|---|---|---|---|
| **ASSETS** | | | |
| Cash, cash equivalents, and investments | $ 65,290 | $ 78,552 | $ (13,262) |
| Other assets | 1,490 | 3,227 | (1,737) |
| TOTAL | $ 66,780 | $ 81,779 | $ (14,999) |
| **LIABILITIES AND FUND EQUITY** | | | |
| LIABILITIES: | | | |
| Unpaid losses and loss adjustment expenses | $ 62,962 | $ 25,995 | $ 36,967 |
| Unearned premiums | 244 | 316 | (72) |
| Accounts payable and other liabilities | 3,380 | 1,315 | 2,065 |
| Total liabilities | 66,586 | 27,626 | 38,960 |
| FUND EQUITY: | | | |
| Invested in capital assets | 33 | 39 | (6) |
| Restricted by statute | 161 | 54,114 | (53,953) |
| Total fund equity | 194 | 54,153 | (53,959) |
| TOTAL | $ 66,780 | $ 81,779 | $ (14,999) |

**Assets** — Total assets of the Fund were $66.8 million as of December 31, 2009, a decrease of $15 million or 18% from December 31, 2008. Of the Fund's assets, more than 98% are represented by cash and investments. The Fund does not have a significant investment in capital assets.

Cash, cash equivalents, and investments were $65.3 million as of December 31, 2009, a decrease of $13.3 million from December 31, 2008. The decrease is primarily due to an increase in claim payments. 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 $1.5 million as of December 31, 2009, a decrease of $1.7 million or 54% from December 31, 2008. The decrease is the result of a decline in interest receivable from decreased earning rates in the State's SMIF and decrease in reinsurance receivable as a result of higher number of claims being paid.

**Liabilities** — The Fund's liabilities were $66.6 million as of December 31, 2009, an increase of $39 million or 141% from December 31, 2008.

The reserve for unpaid losses and loss adjustment expenses was $63 million as of December 31, 2009, an increase of $37 million from December 31, 2008. The increase in the loss reserve is the result of the Fund's higher loss reserves required to cover potential losses. As of December 31, 2009, 2505 insured loans with balances aggregating $661 million were either reported as delinquent by the lender or delinquent but not reported. As of December 31, 2008, 1076 insured loans with balances aggregating $292.6 million were either reported as delinquent by the lender or delinquent but not reported.

Unearned premiums were $244,000 as of December 31, 2009, a decrease of $72,000 from December 31, 2008. The decrease was due to policy adjustments between the servicer and reinsurer. The expected trend of this account is to decrease over time 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.

Accounts payable and other liabilities were $3.4 million as of December 31, 2009, an increase of $2.1 million from December 31, 2008. This increase is largely attributable to amounts owed to the reinsurer for claim payments.

**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 decreased by $54 million as a result of increased reserves for unpaid losses and loss adjustment expenses.

## CONDENSED STATEMENTS OF REVENUES AND EXPENSES

The following table presents condensed statements of revenues and expenses for the Fund for the years ended December 31, 2009 and 2008, and the change from year to year (dollars in thousands):

| | 2009 | 2008 | Change |
|---|---|---|---|
| OPERATING REVENUES: | | | |
| Premiums earned | $ 20,894 | $ 22,062 | $ (1,168) |
| Investment income | 924 | 2,406 | (1,482) |
| Other revenues | 2 | 935 | (933) |
| Total operating revenues | 21,820 | 25,403 | (3,583) |
| OPERATING EXPENSES: | | | |
| Loss and loss adjustment expenses | 60,632 | 26,068 | 34,564 |
| Operating expenses | 14,940 | 16,171 | (1,231) |
| Other expenses | 207 | 34 | 173 |
| Total operating expenses | 75,779 | 42,273 | 33,506 |
| OPERATING LOSS | $ (53,959) | $ (16,870) | $ (37,089) |

**Operating Revenues** — Operating revenues were $21.8 million during 2009 compared to $25.4 million during 2008, a decrease of $3.6 million or 14%.

Premiums earned in 2009 decreased by $1.2 million or 5% compared to premiums earned in 2008. The decrease in premiums earned corresponds with the decrease in insurance in force. Insurance in force was $2.8 billion and $3.1 billion as of December 31, 2009 and 2008, respectively.

Investment income decreased $1.5 million to $924,000 in 2009 from $2.4 million in 2008. This decrease was due to the decrease in interest rates. SMIF interest rates for the past two years are shown in the following table:

| Periods | Year 2009 | Periods | Year 2008 |
|---|---|---|---|
| January — March | 1.903% | January — March | 4.174% |
| April — June | 1.512% | April — June | 3.108% |
| July — September | 0.889% | July — September | 2.769% |
| October — December | 0.594% | October — December | 2.533% |

Other revenues decreased by $933,000 to $2,000 in 2009 from $935,000 in 2008. Recoveries made on amounts owed from defendants in certain litigation declined from last year

**Operating Expenses** — Total operating expenses were $75.8 million during 2009 compared to $42.3 million during 2008, an increase of $33.5 million or 79%.

Loss and loss adjustment expenses increased by $34.6 million in 2009. The increase is attributable to the increase in required reserves to cover potential losses.

The Fund's operating expenses were $14.9 million during 2009 compared to $16.2 million during 2008, a decrease of $1.3 million or 7.6%. The decrease is primarily a result of lower ceded premiums to the reinsurer due to lower insurance in force and a decrease in salary expenses.

**Operating Loss** — Operating loss for 2009 was $53.9 million compared to $16.9 million loss in 2008, a decrease of $37 million. The decrease in operating income is a result of the increase in loss and loss adjustment expenses.

## CALIFORNIA HOUSING LOAN INSURANCE FUND

**BALANCE SHEETS**
**DECEMBER 31, 2010 AND 2009**

| | 2010 | 2009 |
|---|---|---|
| **ASSETS** | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 34,556 | $ 38,702 |
| Investment in Surplus Money Investment Fund | 28,046,000 | 65,251,000 |
| Interest receivable | 39,120 | 101,960 |
| Other current assets | 932,340 | 1,219,689 |
| Total current assets | 29,052,016 | 66,611,351 |
| NONCURRENT ASSETS — Other assets | 47,868 | 168,795 |
| TOTAL | $29,099,884 | $66,780,146 |
| **LIABILITIES AND FUND EQUITY (DEFICIT)** | | |
| CURRENT LIABILITIES: | | |
| Reserves for unpaid losses and loss adjustment expenses | $49,596,140 | $62,962,465 |
| Unearned premiums | 167,412 | 210,244 |
| Reinsurance payable | 3,400,461 | 2,927,223 |
| Accounts payable and other liabilities | 36,437 | 41,423 |
| Compensated absences | 123,571 | 162,852 |
| Due to other government entities | 504,081 | 248,003 |
| Total current liabilities | 53,828,102 | 66,552,210 |
| NONCURRENT LIABILITIES — Unearned premiums | 7,250 | 33,409 |
| Total liabilities | 53,835,352 | 66,585,619 |
| CONTINGENCIES (Note 8) | | |
| FUND EQUITY (DEFICIT) | | |
| Invested in capital assets | 28,017 | 33,446 |
| Restricted | | 161,081 |
| Unrestricted | (24,763,485) | |
| Total fund equity (deficit) | (24,735,468) | 194,527 |
| TOTAL | $29,099,884 | $66,780,146 |

See notes to financial statements.

# CALIFORNIA HOUSING LOAN INSURANCE FUND

## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY
## YEARS ENDED DECEMBER 31, 2010 AND 2009

| | 2010 | 2009 |
|---|---|---|
| OPERATING REVENUES: | | |
| Premiums earned | $ 16,502,060 | $ 20,894,083 |
| Investment income | 255,364 | 924,475 |
| Other revenues | 7,950 | 1,708 |
| Total operating revenues | 16,765,374 | 21,820,266 |
| OPERATING EXPENSES: | | |
| Loss and loss adjustment expenses — net of recoveries | 29,726,646 | 60,632,179 |
| Operating expenses | 11,958,518 | 14,939,801 |
| Other expenses | 10,205 | 207,062 |
| Total operating expenses | 41,695,369 | 75,779,042 |
| OPERATING LOSS | (24,929,995) | (53,958,776) |
| FUND EQUITY — Beginning of year | 194,527 | 54,153,303 |
| FUND EQUITY (DEFICIT) — End of year | $ (24,735,468) | $ 194,527 |

See notes to financial statements.

# CALIFORNIA HOUSING LOAN INSURANCE FUND

## STATEMENTS OF CASH FLOWS
## YEARS ENDED DECEMBER 31, 2010 AND 2009

| | 2010 | 2009 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Receipts from customers | $ 16,621,849 | $ 21,256,237 |
| Payments to suppliers | (10,867,526) | (12,363,168) |
| Payments to employees | (461,021) | (322,490) |
| Due to California Housing Finance Fund | 256,078 | (224,144) |
| Other payments | (43,076,730) | (22,931,801) |
| Net cash used in operating activities | (37,527,350) | (14,585,366) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale of investments | 88,050,000 | 35,089,000 |
| Purchase of investments | (50,845,000) | (21,800,000) |
| Interest on investments | 318,204 | 1,322,720 |
| Net cash provided by investing activities | 37,523,204 | 14,611,720 |
| (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (4,146) | 26,354 |
| CASH AND CASH EQUIVALENTS — Beginning of year | 38,702 | 12,348 |
| CASH AND CASH EQUIVALENTS — End of year | $ 34,556 | $ 38,702 |
| RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES: | | |
| Operating loss | $ (24,929,995) | $ (53,958,776) |
| Adjustments to reconcile operating loss to net cash used in operating activities: | | |
| Interest on investments | (255,364) | (924,475) |
| Unpaid loss and loss adjustment expenses | (13,366,325) | 36,967,898 |
| Depreciation expense | 5,429 | 5,429 |
| Deferred policy acquisition expense | 205,775 | 268,589 |
| Changes in certain operating assets and liabilities: | | |
| Other assets | 197,072 | 1,064,057 |
| Unearned premiums | (68,991) | (72,253) |
| Reinsurance payable | 473,238 | 2,118,299 |
| Compensated absences | (39,281) | 162,852 |
| Accounts payable and other liabilities | (4,986) | 7,158 |
| Due to California Housing Finance Fund | 256,078 | (224,144) |
| NET CASH USED IN OPERATING ACTIVITIES | $ (37,527,350) | $ (14,585,366) |

## 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 , 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 Agency. As of June 30, 2010, the Agency had total assets of $11.56 billion and fund equity of $1.55 billion (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 $831.1 million and $1.02 billion at December 31, 2010 and 2009, respectively. Of the insured first mortgage loans outstanding at December 31, 2010, 85.7% have loan-to-value ratios, measured as of the funding date of the loan, equal to or greater than 90%.

The Fund's reserve for loan losses decreased during 2010 as a result of the slight decrease in the number of insured California home mortgage delinquencies. In December 2010, Moody's Investors Service lowered the Fund's rating to "Caa3" from "B2" primarily due to the continued level of home mortgage delinquencies which leads to uncertainty over the levels of potential claims to be experienced. In September 2010, S&P lowered the Fund's rating to "CC" from "CCC-" and withdrew the ratings on the Fund at the Agency's request. The counterparty credit and financial strength ratings of the Fund's reinsurer, Genworth Mortgage Insurance Corporation ("Genworth"), remained at Moody's rating of "Baa2". In September 2010, Standard and Poor's Ratings Services ("S&P") affirmed the counterparty credit and financial strength ratings on Genworth at "BBB-".

## 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.

The financial statements of the Fund were prepared using generally accepted accounting principles that are applicable to a going concern. Management of the Fund, however, has concluded that there is substantial doubt as to the Fund's ability to continue to meet its designated purpose of paying claims and expenses. The financial statements of the Fund do not include any adjustments that might result from the outcome of this uncertainty. As of December 31, 2010, the Fund's cash and cash equivalents are not sufficient to meet the Fund's total anticipated cash requirements to pay its obligations over the next twelve months. Management believes that attempts to raise any additional capital will be unsuccessful and does not believe that, under the terms of the agreement with the CHFF, the Fund will be able to draw on the interfund credit agreement (see note 6). It is anticipated that the Fund will first deplete its available funds to pay claims and expenses sometime during the third quarter of 2011. Subsequent to that event, the Fund will continue to receive its share of premiums from policies still in force and will use the premiums received along with any other available funds to pay the Fund's obligations on a "first-in, first-out" basis in the order in which the claims and expenses are received.

**Accounting and Reporting Standards** — The Fund follows the Standards of Governmental Accounting and Financial Reporting, as promulgated by the Governmental Accounting Standards Board (GASB). The Fund has adopted the option under GASB Statement No. 20, which allows the Fund 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 assets and 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 Fund 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 (SMIF) to be cash and cash equivalents.

**Investments** — The Agency invests the Fund's excess cash in 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. 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 $140,779 and $346,554 as of December 31, 2010 and 2009, 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 Fund'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, restricted equity or unrestricted 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. Unrestricted equity represents equity not restricted for any purpose.

**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, as well as the losses associated with these 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 Fund entered into a reinsurance treaty and administrative services agreement with 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.

## 3. INVESTMENT RISK FACTORS

There are many factors that can affect the value of investments. Some, such as credit risk, custodial credit risk, concentration of credit risk, and interest rate risk, may affect both equity and fixed-income securities. Equity and debt securities respond to such factors as economic conditions, individual company earning performance, and market liquidity, while fixed income securities are particularly sensitive to credit risks and changes in interest rates. It is the investment policy of the Fund to invest substantially all of its funds in fixed income securities, which limit the Fund's exposure to most types of risk.

Investments by type at December 31, 2010 and 2009, consist of the following:

| | 2010 | 2009 |
|---|---|---|
| Surplus Money Investment Fund — State of California | $28,046,000 | $65,251,000 |
| Total investments | $28,046,000 | $65,251,000 |

**Credit Risk** — Fixed income securities are subject to credit risk, which is the chance that an issuer will fail to pay interest or principal in a timely manner or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline. Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk. At December 31, 2010, the Fund does not have any investments exposed to credit risk.

**Custodial Credit Risk** — Custodial credit risk is the risk that in the event of the failure of the custodian, the investments may not be returned. At December 31, 2010, the Fund did not have any investments exposed to custodial credit. All investments are held by the State of California.

**Concentration of Credit Risk** — Concentration of credit risk is the risk associated with a lack of diversification, such as having substantial investments in a few individual issuers, thereby exposing the Fund to greater risks resulting from adverse economic, political, regulatory, geographic, or credit developments. At December 31, 2010, the Fund does not have any investments exposed to concentration of credit risk.

**Interest Rate Risk** — Interest rate risk is the risk that the value of fixed income securities will decline due to decreasing interest rates. The terms of a debt investment may cause its fair value to be highly sensitive to interest rate changes. At December 31, 2010, the Fund does not have any debt investments that are highly sensitive to changes in interest rates.

**Effective Duration** — The effective duration is the approximate change in price of a security resulting from a 100 basis points (one percentage point) change in the level of interest rates. It is not a measure of time. The Fund's investments are not affected by effective duration.

## 4. RESERVES FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

The following tables summarize the changes in the reserves for unpaid losses and loss adjustment expenses for the years ended December 31, 2010 and 2009. The first table presents reserves on a gross basis (before reinsurance) and the second table presents the reserve on a net basis (after reinsurance). The total net reserve for loss and loss adjustment is reflected in the financial statements.

| **Gross** | **2010** | **2009** |
|---|---|---|
| Gross reserve for loss and loss adjustment — beginning of year balance | $ 241,981,953 | $ 102,625,159 |
| Incurred (recovered) related to: | | |
| Provision attributable to the current year | 142,838,171 | 225,315,250 |
| Change in provision attributable to prior years | (30,061,583) | 8,363,936 |
| Total incurred | 112,776,588 | 233,679,186 |
| Payments related to: | | |
| Current year | (13,152,683) | (11,507,215) |
| Prior years | (154,147,316) | (82,815,177) |
| Total payments | (167,299,999) | (94,322,392) |
| Gross reserve for loss and loss adjustment — end of year balance | $ 187,458,542 | $ 241,981,953 |

| **Net of Reinsurance** | **2010** | **2009** |
|---|---|---|
| Net reserve for loss and loss adjustment — beginning of year balance | $ 62,962,464 | $ 25,994,567 |
| Incurred (recovered) related to: | | |
| Provision attributable to the current year | 37,679,992 | 58,695,589 |
| Change in provision attributable to prior years | (7,953,346) | 1,936,589 |
| Total incurred | 29,726,646 | 60,632,178 |
| Payments related to: | | |
| Current year | (3,557,738) | (2,962,534) |
| Prior years | (39,535,232) | (20,701,747) |
| Total payments | (43,092,970) | (23,664,281) |
| Net reserve for loss and loss adjustment — end of year balance | $ 49,596,140 | $ 62,962,464 |

The change in provision attributable to prior year (net of reinsurance) decreased by $7.9 million for the year ended December 31, 2010 due to a decrease in loan delinquencies from the year ended December 31, 2009, while the change in provision attributable to prior year (net of reinsurance) increased by $1.9 million for the year ended December 31, 2009 from the year ended December 31, 2008 due to an increase in loan delinquencies.

Reserves for loss and loss adjustment expenses relate to delinquent loans, net of reinsurance. Such estimates were based on historical experience, which management believes is 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.

## 5. REINSURANCE

Effective March 1, 2003, the Fund entered into a 75% quota share reinsurance agreement with Genworth to reinsure most (currently, approximately 96%) of the Fund's 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 treaty was amended for loans insured on or after May 1, 2008 to cede 67% of premiums collected and amended again on April 1, 2009 to cede 69% of premiums collected on loans insured on or after that date. However, there are no loans currently ceded at 69%. The Fund'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 its obligations under the reinsurance agreement. The amount of earned premiums ceded to Genworth for the years ended 2010 and 2009 was $10.4 million and $13.2 million, respectively.

## 6. 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 $323,640 and $132,693 at December 31, 2010 and 2009, respectively. For the years ended December 31, 2010 and 2009, total expenses allocated to the Fund by the Agency were $1,349,755 and $1,052,616, respectively.

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 interfund 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.

Initially, the Agency Executive Director established an interfund 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. The amount by which the fund may borrow was reduced to $10,000,000 from $100,000,000 during 2009. Interest rates and repayment terms are determined upon receipt of a request to draw on this credit facility.

Pursuant to the terms of the Board Resolution and the interfund credit agreement, the credit line is no longer legally available to the Fund. The credit agreement stipulates that the amount of credit is determined to be an amount necessary to maintain or improve the claims paying rating of the Fund, which at the time was "A+", and such amount shall not impair or adversely affect the Agency credit rating or any CHFF bond credit rating. The claims paying rating of the Fund was "A+" until July 2009 when it was lowered to "BBB" and subsequently fell as low as "CCC-" during 2010. In September 2010, management of the Fund decided to withdraw the rating. Consequently, there is no credit line currently available under the interfund agreement as there is no rating to support and the $10 million would not resurrect the "CCC-" claims paying rating back to "A+".

## 7. .PENSION PLAN AND POST RETIREMENT BENEFITS

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 postretirement 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, 2011, 2010, and 2009, the employer contribution rates were as follows:

| | June 30 | | |
|---|---|---|---|
| | **2011** | **2010** | **2009** |
| State Miscellaneous Member First Tier | 19.922 % | 16.917 % | 16.574 % |
| State Miscellaneous Member Second Tier | 19.622 | 16.737 | 16.470 |

The Fund's contributions to the PERF for the years ended December 31, 2010, 2009, and 2008, were $136,045, $67,463, and $95,849, respectively, equal to the required contributions for each 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, 2009, which actuarial assumptions included (a) 7.75% investment rate of return compounded annually, (b) projected salary increases that vary by duration of service, and (c) overall payroll growth factor of 3.25% annually. Both (a) and (c) included an inflation component of 3% and a 0.25% per annum productivity increase assumption.

The most recent actuarial valuation of the PERF indicated that there was an unfunded actuarial accrued liability. The amount of the underfunded 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, are presented in the June 30, 2010, CalPERS CAFR.

GASB Statement 45 requires states and local governments to publicly disclose the future dollar amount of their obligations to pay for Other Postemployment Benefits (OPEB), like healthcare, that are provided to retired employees, including retired public employees. The OPEB is a cost-sharing multiple-employer defined benefit healthcare plan administered by CalPERS. State Controller's Office sets the employer contribution rate based on the annual required contribution of the employers (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) of the plan over a period not to exceed thirty years. The Fund's estimated unfunded OPEB cost was $180,440 and $115,310 for the years ended December 31, 2010 and 2009 respectively, and this liability was added to Personal Services in the respective year. CalPERS issues a publicly available CAFR that includes financial statements and required supplementary information for the OPEB.

## 8. LITIGATION

On June 14, 2002, the Agency filed a complaint in the case of California Housing Finance Agency (CalHFA) v. Hanover California Management and Accounting Center Inc., (HC) et al, Orange County Superior court #02CC10634 (Action). The trial in this matter has concluded and the Agency prevailed on all causes of action. The jury awarded $6.7 million in damages, prejudgment interest of $1 million, and finally the jury found that the defendants acted with malice, and awarded total punitive damages of $1.5 million. The defendants appealed the judgment and the Court of Appeal issued a decision affirming the judgment in full. The decision is now final.

The amounts received from the defendants were $7,950 and $1,895 during the years ended December 31, 2010 and 2009, respectively which is recorded as other revenue in the accompanying Statements of Revenues, Expenses, and Changes in Fund Equity. It is highly unlikely that any additional amounts will be received and as such no gain contingency has been recorded.

Certain other lawsuits and claims arising in the ordinary course of business have been filed or are pending against the Fund. 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.

## 9. SUBSEQUENT EVENTS

Prior to February 2011, Genworth was paying the full amount of the loss (100%) to the insured and was billing CaHLIF for its portion of the loss (approximately 25%) each month. Effective February 1, 2011, Genworth is paying for their portion of the loss (generally 75%) directly to the insured and the Fund is paying for its portion of the loss (generally 25%) directly to the insured.

On February 2, 2011, Standard and Poor's lowered the rating of Genworth to "BB+" from "BBB-". The rating was lowered due to reported fourth quarter and full-year losses that significantly exceeded expectations.

On February 3, 2011, Moody's placed the current rating of "Baa2" for Genworth on review for possible downgrade.

Management has evaluated subsequent events during the period from December 31, 2010 to May 5, 2011, the date the financial statements were available to be issued.

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