Moody's Upgrades California Housing Finance Agency Multifamily III Bonds to A1, assigns A1 to 2014 Series A Multifamily III Bonds

Approximately $536 million of parity debt outstanding; $38.9 million par amount of 2014 Series A Bonds to be issued

CALIFORNIA HOUSING FINANCE AGENCY - MULTI-FAMILY HOUSING REVENUE BONDS III CALIFORNIA HOUSING FINANCE AGENCY State Housing Finance Agencies California

Moody's Rating

Issue	Rating
Multifamily Housing Revenue Bonds III 2014 Series A Bonds	A1
Sale Amount $38,915,000	
Expected Sale Date 03/28/14	
Rating Description Housing Finance Agency Pledge	

Moody's Outlook - STA

NEW YORK, March 27, 2014 -- Moody's Investors Service has upgraded the long-term underlying rating on California Housing Finance Agency's Multifamily Housing Revenue Bonds III (MF III Bonds) to A1 from A3. (Moody's has also assigned an A1 rating to the Agency's Multifamily Housing Revenue Bonds III, 2014 Series A to be issued on parity with the outstanding MFIII Bonds. The outlook on the ratings is stable. This action does not affect enhanced ratings on the variable rate demand bonds outstanding under MFIII and does not affect any other ratings of the Agency or its debt. Today's action concludes the review for upgrade initiated on March 4, 2014.

RATINGS RATIONALE

The A1 rating reflects significant growth in the financial strength of the MFIII indenture, strong performance of the mortgage loans pledged to bond repayment, and performance on stress cash flow projections. It reflects the general obligation pledge of the Agency, although the increased credit strength of the MFIII program makes the need for additional Agency support less likely. The rating is constrained by potential cash flow stress from a high level of variable rate debt and related interest rate swaps, which could lead to scenarios where Agency support is required.

The rating assigned to the 2014 Series A Bonds reflects the rating of the MFIII indenture, and takes into account insurance on the underlying mortgages under the FHA Risk Sharing Program which provides a high level of protection against losses from loan defaults.

The outlook on the ratings is stable based on financial performance, loan performance and positive trends in the resources available to absorb stress from variable rate debt and swaps.

Strengths

Strong financial position reflected by increased asset- to- debt ratio and profitability

First lien pledge on multifamily mortgage loans with strong credit quality

Cash flow projections that demonstrate ability to repay debt in stress scenarios, including high and low interest rates, expiration of external liquidity facilities and loan defaults

General obligation pledge of the Agency

Federal support through external liquidity facilities supporting variable rate demand bonds (VRDBs) from the TCLP program on favorable terms

Active Agency financial management

Challenges

High level of variable rate debt

TCLP liquidity facilities expire 12/23/15, leading to potential bank bond amortization that places stress on cash flow projections

Complex portfolio of interest rate swaps causes counterparty and basis risk; regular swap payments are made from the indenture; program is over-hedged, reducing profitability

DETAILED CREDIT DISCUSSION

BACKGROUND

MFIII was the Agency's active multifamily financing program from its creation in 1997 until 2008. Bonds were issued to finance mortgage loans for affordable rental housing developments in California, under a parity indenture with all of the bonds secured equally by all of the mortgage loans. The bonds are secured by a first-lien pledge on the financed mortgage loans, as well as by a general obligation pledge of the Agency. The legal structure provides for deposit of revenues with the trustee, to be applied (after payment of fiduciary fees) to pay bond interest and principal, meet reserve requirements (if any) and fund redemptions of mortgage loans. After satisfaction of these requirements, funds can be released free and clear of the Indenture lien only upon filing of an Officer's certificate demonstrating that future debt service obligations can be met and assets will exceed liabilities. The 2014 Series A Bonds will be the first issuance of MFIII Bonds since 2008.

FINANCIAL PERFORMANCE AND ASSET QUALITY DRIVE RATING UPGRADE

MF III's financial increased financial strength is a key factor in today's upgrade, providing a cushion against potential losses and decreasing the indenture's reliance on the external financial support from the Agency. MFIII's adjusted asset to debt ratio increased form 1.16x to 1.25x from 6/30/12 to 6/30/13. The increase in over-collateralization reflects the Agency's use of excess indenture revenues together with proceeds of loan prepayments to redeem bonds. It also reflects the Agency's election to make deposits of cash from its general fund into the MFIII indenture totaling $57.1 million since the beginning of the year to redeem bonds and further strengthen MFIII's financial performance. Although the Agency may chose to devote additional resources to further strengthen the MFIII indenture, the rating reflects our analysis that the MFIII indenture can meet its obligations and withstand stress cash flow projections appropriate to the rating without the need for further contributions from the general fund.

Profitability also increased, with net revenues as a percentage of total of 15%, 23% and 49% for FY 11, FY12 and FY13 respectively, reflecting the increased over-collateralization. The strong profitability reflects the positive spread between mortgage yield and bond costs. The jump in net revenues in FY 13 reflected a high level of non-operating revenues from mortgage loan prepayments fees.

Going forward we expect financial performance to remain stable or strengthen. The Agency recently began to permit loan prepayments (a shift from a long-standing policy of not allowing prepayments) as part of its housing preservation strategy; prepayments are applied to bond redemptions that increase asset- to- debt ratios. The Agency expects to issue additional bonds going forward, which we expect will contribute to revenue growth and profitability.

The quality of MFIII's mortgage loan assets also contributes to today's upgrade. Under the indenture, the MFIII Bonds are supported by a pledge of revenues from the portfolio of mortgage loans financed with bond proceeds. The portfolio of 280 loans and mortgage-backed securities provides financing for 226 affordable multifamily rental developments in California (as of 6/30/13). The portfolio demonstrates strong performance, with average debt service coverage of 1.5x and average occupancy at 97%. 26% of the loans (by principal balance) benefit from FHA Risk Sharing Insurance, and 4% are securitized through Fannie Mae, with the remaining 70% of the loans have no credit enhancement. The Agency expects future issuance to add mortgage loans with FHA Risk Sharing Insurance. Delinquencies and defaults have been minimal, and currently the Agency reports no delinquencies among the loans.

VARIABLE RATE DEBT AND SWAPS ARE KEY CHALLENGES

MFIII's high level of variable rate debt poses potential medium-to-long term challenges to cash flows that currently constrain further upward movement of the rating. As of 6/30/13, 66.95% of bonds were variable rate ($412.3 million par amount), including 49.72% that are VRDBs ($306.2 million par amount) and 17.23% with no bondholder tender features (auction bonds). Through redemptions the balance of variable rate bonds has been reduced to $342 million par amount ($240.7 million par amount of VRDBs) at 3/1/14, but the percentages remain high at 63.9% total variable rate bonds and 44.9% VRDBs.

All of the VRDBs are supported by credit and liquidity facilities provided by Fannie Mae and Freddie Mac through the federal government's TCLP program that was instituted in 2009 to provide liquidity support for state HFA VRDBs. The facilities provide liquidity for bondholder tenders. All of the TCLP facilities currently expire on December 23, 2015. If the facilities are not renewed or replaced by that date, remaining VRDBs will become bank bonds bearing interest at elevated rates, and must be repaid in full by12/23/22 (although there is no fixed term-out of principal as is usually required in liquidity facilities from private-sector financial institutions). The Agency has redeemed VRDBs to reduce this exposure, but repayment of remaining bank bonds by 12/23/22 creates potential stress in cash flow scenarios.

The variable rate bonds are combined with interest rate swaps that provide a hedge against interest rate risk. The swaps had a notional amount as of 6/30/13 of $557.1 million, down to $492.3 million as of 2/1/14. The swaps are general obligations of the Agency. Regularly scheduled net swap payments are required to be paid from the MFIII Indenture on par with bond interest. Following redemptions of VRDBs towards reduction of the potential TCLP exposure, the Indenture is over-hedged (swap notional is greater than variable rate par outstanding). The notional amount of swaps will decrease over time according to scheduled reductions built into the swaps.

Swap payments other than regular payments including any collateral positing or termination payments, generally may be paid from indenture funds only to the extent of amounts available for withdrawal by the Agency free and clear of the Indenture, protecting the indenture from exposure to mark-to-market payments (the Agency reports mark-to-market at 2/5/14 at approximately $80.3 million). The swaps are diversified among eight counterparties with ratings ranging from Baa2 to Aa3.

CASH FLOW PROJECTIONS DEMONSTRATE ABILITY TO WITHSTAND STRESS FACTORS

We have reviewed cash flow projections for MFIII, including stress projections that include high- and low-interest rate scenarios according to our methodology, combined with repayment of bank bonds assuming TCLP is not renewed as well as loss scenarios as mortgage loans. The cash flows demonstrate that MFIII can pay debt service through the term of the bonds under all scenarios without external support, which is a factor supporting a rating that is higher than the rating of the Agency's senior unsecured rating.

2014 SERIES A BONDS

The 2014 Series A Bonds are expected to be issued on parity with the outstanding MFIII bonds, and the rating assigned to the 2014 Series A Bonds is based on the pledge of the indenture. The issuance of $38.9 million bonds is expected to finance mortgage loans on three rental properties, with the mortgage amount equal to the par amount of bonds and positive cash flow contributing to indenture strength. Costs of issuance and contributions for capitalized interest will be funded by the Agency. Each of the acquisition/rehabilitation loans will be insured under the FHA Risk Sharing Program under Section 542 (c) of the National Housing Act at initial closing. Risk Sharing provides insurance for 100% of loan principal upon a mortgage default. Funds will be deposited in the Indenture's debt service reserve sufficient to provide liquidity until receipt of an insurance claim. The Agency expects that future issuance under the MFIII indenture will finance mortgage loans with Risk Sharing insurance.

OUTLOOK

The outlook on the ratings is stable, reflecting the expectation that financial performance, asset quality, and cash flow will continue in the near term .

What Could Change the Rating Up

Reduced exposure to VRDB related risks, including through redemptions/refunding of bonds or extension/replacement of liquidity facilities on favorable terms

Substantial and sustained improvement in asset-to-debt ratio and profitability

Meaningful and permanent reduction in swap exposure

What Could Change the Rating Down

Weakened financial performance, with decreasing asset to debt ratios or decreasing profitability

Weaker performance of loan portfolio, including delinquencies and/or declining loan debt service coverage, leading to weaker risk-adjusted indenture net assets and higher potential loan losses

Increased risk arising from replacement of external liquidity facilities for VRDBs on less favorable terms

Cash flows indicate that direct Agency financial contributions may be needed to withstand stress scenarios

Downgrades of swap counterparties

The principal methodologies used in this rating were Moody's Approach to Analyzing Pools of Multifamily Properties published in October 2001 and Moody's Methodology for Assigning Issuer Ratings to Housing Finance Agencies published in May 2001. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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