MOODY'S
INVESTORS SERVICE

Rating Update: Moody's affirms A1 rating for California Housing Finance Agency's Multifamily Housing Revenue Bonds III

Global Credit Research - 13 Nov 2014

Approximately $468 million of parity debt outstanding

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

Opinion

NEW YORK, November 13, 2014 --Moody's Investors Service has affirmed the A1 long-term underlying rating on California Housing Finance Agency's Multifamily Housing Revenue Bonds III (MFIII Bonds--$468.7 million outstanding as of November 1, 2014). The outlook on the rating 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.

SUMMARY RATINGS RATIONALE

The rating is based on 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. The rating reflects the general obligation pledge of the Agency, and also reflects increased credit strength making the need for additional Agency support less likely. It balances these strengths with 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 outlook on the rating 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

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 and expiration of external liquidity facilities

General obligation pledge of the Agency

Solid legal structure

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

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

RECENT DEVELOPMENTS: All of the program's variable rate demand bonds are currently supported by credit and liquidity facilities provided by Fannie Mae and Freddie Mac through the federal government's TCLP program. The Agency expects to replace over half of the TCLP facilities with Letters of Credit from JPMorgan Chase Bank, National Association (Aa3/P-1/Stable outlook) on November 19, 2014.

DETAILED RATING RATIONALE

LOAN PORTFOLIO: Quality Mortgage Loans Exhibit Strong Performance

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. The portfolio demonstrates strong performance, with portfolio-wide debt service coverage of 1.5x and average occupancy at 97%. Twenty-six percent of the loans (by principal balance) benefit from FHA Risk Sharing Insurance, and 4% are securitized through Fannie Mae; 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.

FINANCIAL POSITION: Program's asset-to-debt ratio continues to strengthen

MF III's increased financial strength provides a cushion against potential losses and decreases the indenture's reliance on the external financial support from the Agency. MFIII's adjusted asset to debt ratio increased from 1.25x to 1.48x from 6/30/13 to 6/30/14. The increase in over-collateralization reflects the Agency's use of excess indenture revenues, and deposits from the Agency's general fund, in addition to proceeds of loan prepayments, to redeem bonds. Profitability is strong, with net revenues as a percentage of total revenues of 23%, 49% and 17% for FY 12, FY13 and FY14, respectively, reflecting the increased over-collateralization. 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 permits 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.

LIQUIDITY: Cash flow projections demonstrate that the program exhibits sufficient liquidity to meet all debt service obligations.

BOND PROGRAM STRUCTURE: Variable Rate Debt and Swaps Are Key Challenges

Debt Structure: The total outstanding debt for MFIII as of November 1, 2014 is $468,785,000, of which $216,430,000 is fixed rate, and $252,355,000 is variable rate.

Debt-Related Derivatives:

MFIII's high level of variable rate debt poses potential medium-to-long term challenges to cash flows. As of 11/1/14, 53.83% of bonds were variable rate ($252.355 million par amount), including 33.08% that are VRDBs ($155.080 million par amount) and 20.75% with no bondholder tender features.

Currently, 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 or before 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 by 12/22/23 (although there is no fixed term-out of principal as is usually required in liquidity facilities from private-sector financial institutions). The Agency expects to replace over half of the TCLP facilities with LOCs from JPMorgan on November 19, 2014. The Agency has redeemed VRDBs to reduce this exposure, but repayment of remaining bank bonds by 2023 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 6/30/14 of $492.325 million. 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 posting 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 6/30/14 at approximately $94.5 million). The swaps are diversified among eight counterparties with ratings ranging from Baa2 to Aa2.

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 and the JPMorgan LOCs are not renewed. 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.

Pensions and OPEB: Not a material factor for this rating action.

MANAGEMENT AND GOVERNANCE:

Since 2008, CalHFA's management has taken effective steps to improve the Agency's finances and demonstrated management focus on reducing financial stress. The Agency has substantially enhanced its single family asset management function and reduced timelines for moving defaulted loans through the pipeline. The Agency has also worked proactively to improve the Agency's balance sheet to address the combined effect of the mortgage decline and the financial crisis. Actions have included mortgage loan sales, bond purchases at a discount, refinancing of multifamily projects to reduce risk to the Agency, negotiation of more favorable terms for swap collateral posting, refunding to reduce variable rate debt, and exercise of par swap termination options to reduce exposure. The Agency has taken steps to revive its lending programs, including reopening its mortgage origination business (through securitization of whole loans) and increasing its focus on multifamily loans.

KEY STATISTICS:

- Total Bonds Outstanding (as of November 1, 2014): $468,785,000

- Asset-to-Debt Ratio (as of June 30, 2014): 1.48

- Profitability (as of June 30, 2014): 17.48%

- Delinquent Loans: None

- Variable rate debt as % of bonds outstanding: 53% (including auction rate securities)

- Swapped debt as % of variable debt: 195%

OBLIGOR PROFILE:

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 Agency issued $38.9 million of MFIII bonds in March, 2014, which was the first issuance since 2008. The Agency expects future issuance to add mortgage loans with FHA Risk Sharing insurance.

LEGAL SECURITY:

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 (A3, stable outlook). 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.

USE OF PROCEEDS: Not applicable.

OUTLOOK

The outlook on the rating is stable, based on financial performance, asset quality and ability to meet stress cash flow projections.

What Could Change the Rating Up

Further improvement in the financial position along with continued strong loan performance

Progress in relieving potential stress from VRDB liquidity facility rollover, through redemptions/refunding of bonds or extension/replacement of liquidity facilities

Cash flow projections that continue to demonstrate the ability to withstand stress related to variable rate debt as well as potential loan losses without Agency contributions

What Could Change the Rating Down

Weakened financial performance, with decreasing asset to debt ratios combined with 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

Increasing stress to cash flows from variable rate debt

Lack of progress in replacing external liquidity facilities for VRDBs or redeeming VRDBs before liquidity facility expiration

Cash flows that indicate that direct Agency financial contributions may be needed to withstand stresses from variable rate debt or loan losses

PRINCIPAL METHODOLOGY:

The principal methodology used in this rating was U.S. Housing Finance Agency Multifamily Methodology published in September 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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