CalHFA Master Hedge Policy

Risk Management Procedures
Master Hedge Policy

- Developed to establish guidelines for the use and management of financial derivatives

- Allows for the use of hedges to reduce the interest rate risk of loan commitments

- Will help manage many of the risks inherent in using financial derivatives
Hedge will offset the financial gains and losses due to the timing difference between the rate lock to the borrower and the securitization of the loan.
Why Hedge?

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

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

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

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

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

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

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

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

If any further questions arise, please contact:

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