

Veterans Farm and Home  
Building Fund of 1943,  
Department of Veterans  
Affairs, State of California

Financial Statements for the  
Years Ended June 30, 2010 and 2009, and  
Independent Auditors' Report

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**TABLE OF CONTENTS**

---

	<b>Page</b>
INDEPENDENT AUDITORS' REPORT	1
MANAGEMENT'S DISCUSSION AND ANALYSIS	2-12
FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2010 AND 2009:	
Balance Sheets	13
Statements of Revenues, Expenses, and Changes in Fund Equity	14
Statements of Cash Flows	15
Notes to Financial Statements	16-26

## INDEPENDENT AUDITORS' REPORT

California Veterans Board  
State of California  
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943 (the "Fund"), which is administered by the Department of Veterans Affairs, State of California (the "Department") as of June 30, 2010 and 2009, and the related statements of revenues, expenses, and changes in fund equity and cash flows for the years then ended. These financial statements are the responsibility of the Department's management. 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 respective 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 June 30, 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.

As discussed in Note 1, the financial statements present only the Fund and are not intended to present the financial position of the Department or the results of its operations and its cash flows of its proprietary funds.

Management's Discussion and Analysis on pages 2 through 12 is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and we do not express an opinion on it.

*Deloitte & Touche LLP*

October 13, 2010

# VETERANS FARM AND HOME BUILDING FUND OF 1943

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS FOR THE YEARS ENDED JUNE 30, 2010 AND 2009

---

### Introduction – The Department of Veterans Affairs

The Department of Veterans Affairs (the “Department”) began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature of the Veterans Farm and Home Purchase Act of 1921 (the “Cal-Vet Farm and Home Program” or the “Program”). In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 which modified the Program to meet new needs of California’s veterans. The 1943 Act established the 1943 Fund in the State Treasury and the Department established the Veterans Farm and Home Building Fund of 1943 (the “Fund”), which is the principal fund utilized for the Cal-Vet Farm and Home Loan Program. Financing is provided as installment loans, which are referred to as Contracts of Purchase.

The sales of the Fund’s Home Purchase Revenue Bonds and Veterans General Obligations Bonds combined with monies received from prepayments of Contracts of Purchase and other revenues under the Program not needed at any given time to meet the then current bond retirement schedules and operating costs have financed the purchase of farms and homes since the Program’s inception. Expenditures are primarily for debt service and administration of the Program.

### Fiscal Year 2010 Compared to Fiscal Year 2009

#### Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2010 and June 30, 2009 (dollars in thousands) and the percentage change.

	2010	2009	Change	% Change
<b>ASSETS</b>				
Cash, cash equivalents and investments	\$ 284,355	\$ 322,507	\$ (38,152)	(11.8)%
Receivables under contracts of purchase—net	1,499,938	1,688,016	(188,078)	(11.1)%
Other receivables and assets	67,765	70,501	(2,736)	(3.9)%
<b>TOTAL ASSETS</b>	<u>\$ 1,852,058</u>	<u>\$ 2,081,024</u>	<u>\$ (228,966)</u>	(11.0)%
<b>LIABILITIES AND FUND EQUITY</b>				
Liabilities:				
Bonds payable	\$ 1,667,254	\$ 1,852,512	\$ (185,258)	(10.0)%
Other payables and liabilities	23,085	28,905	(5,820)	(20.1)%
Total liabilities	1,690,339	1,881,417	(191,078)	(10.2)%
Fund Equity	161,719	199,607	(37,888)	(19.0)%
<b>TOTAL LIABILITIES AND FUND EQUITY</b>	<u>\$ 1,852,058</u>	<u>\$ 2,081,024</u>	<u>\$ (228,966)</u>	(11.0)%

### ***Assets***

Total assets decreased by \$229 million from \$2.081 billion at June 30, 2009 to \$1.852 billion at June 30, 2010. This decrease consisted primarily of the following items:

- Total cash, cash equivalents and investments decreased by \$38 million from \$322 million at June 30, 2009 to \$284 million at June 30, 2010. The decrease is a principally due to bond calls and significantly lower interest earned on investments.
- Net receivables under contracts of purchase decreased by \$188 million from \$1.688 billion at June 30, 2009 to \$1.500 billion at June 30, 2010. The change was due to payments received and a decrease in the number of new contracts of purchase added to the portfolio.
- All other receivables and assets decreased by \$3 million from \$71 million at June 30, 2009 to \$68 million at June 30, 2010.

### ***Liabilities and Fund Equity***

Total liabilities decreased by \$191 million from \$1.881 billion at June 30, 2009 to \$1.690 billion at June 30, 2010, principally due to bond calls.

Fund equity decreased by \$37.9 million from \$199.6 million at June 30, 2009 to \$161.7 million at June 30, 2010, as a result of unfavorable holding costs of cash assets, less revenue due to fewer loans processed and increased reserves for uncollectible contracts of purchase and REO losses.

The total assets to liability ratio decreased to 1.10 as of June 30, 2010, from 1.11 as of June 30, 2009.

## Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2010 and June 30, 2009 (dollars in thousands) and the percentage change.

	2010	2009	Change	% Change
<b>PROGRAM OPERATIONS:</b>				
Interest revenues:				
Contracts of purchase	\$ 91,222	\$ 99,058	\$ (7,836)	(7.9)%
Investments and other	<u>4,960</u>	<u>12,261</u>	<u>(7,301)</u>	(59.5)%
Total program operating revenues	96,182	111,319	(15,137)	(13.6)%
Expenses:				
Interest expense	89,519	103,043	(13,524)	(13.1)%
Provision for program losses	<u>19,575</u>	<u>11,293</u>	<u>8,282</u>	73.3 %
Total program operating expenses	<u>109,094</u>	<u>114,336</u>	<u>(5,242)</u>	(4.6)%
Deficiency of program operations revenues over program operations expenses	<u>(12,912)</u>	<u>(3,017)</u>	<u>(9,895)</u>	328.0 %
<b>PROGRAM ADMINISTRATION:</b>				
Total program administration revenues	3,825	2,475	1,350	54.5 %
Total program administration expenses	<u>15,901</u>	<u>18,246</u>	<u>(2,345)</u>	(12.9)%
Excess of program administration expenses over program administration revenues	<u>(12,076)</u>	<u>(15,771)</u>	<u>3,695</u>	(23.4)%
Operations excess (deficiency) of revenues over (under) expenses	(24,988)	(18,788)	(6,200)	33.0 %
(Loss) gain on sale of repossessed property	<u>(12,900)</u>	<u>(3,468)</u>	<u>(9,432)</u>	272.0 %
(Deficiency) excess of revenues (under) over expenses	<u>\$ (37,888)</u>	<u>\$ (22,256)</u>	<u>\$ (15,632)</u>	70.2 %

### *Program Operations*

The deficiency in program operations revenues over program operations expenses increased \$9.8 million from a deficiency of \$3.0 compared to a deficiency of \$12.8 million for the fiscal year ended June 30, 2009 and 2010, respectively, due to the following:

- Interest revenue from contracts of purchase decreased by \$7.9 million from \$99.1 million for the year ended June 30, 2009 to \$91.2 million for the year ended June 30, 2010, due to a decrease in the number of new contracts of purchase to the portfolio.
- Interest revenues on investments decreased by \$7.9 million from \$12.3 million for the year ended June 30, 2009 to \$5.0 million for the year ended June 30, 2010. This decrease is due to the SMIF quarterly interest rate decreasing over the fiscal year from 1.51% at June 30, 2009 to 0.56% at June 30, 2010 combined with a decrease in the cash, cash equivalents and investments during that time.
- Net program operation expenses decreased \$5.2 million from \$114.3 the year ended June 30, 2009 to \$109.1 million for the year ended June 30, 2010. This is due to a decrease of \$13.5 million in interest expense related to a decrease in bonds outstanding, offset by an increase of 8.2 million in the provision for program losses.

- The sale of repossessed properties resulted in a loss of \$12.9 million for the year ended June 30, 2010 compared to a loss of \$3.5 million for the year ended June 30, 2009 due to a reduction in property values from loans made in the calendar years 2005, 2006 and 2007. The Funds' holdings of repossessed properties, net of allowances for losses increased from \$23 million as of June 30, 2009 to \$23.3 million as of June 30, 2010.

### ***Program Administration***

Total program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance and premiums collected by the department for the fire and hazard insurance program. Total program administration revenues decreased by \$13.7 million from \$2.5 million for the year ended June 30, 2009 to a deficiency of \$11.2 million for the year ended June 30, 2010, due to the following:

- The fire and hazard insurance program experienced a decrease in net revenues of \$0.3 million due to claimed losses during the fiscal year.
- Other income decreased by 12.6 million, including a decrease of \$0.8 million related to loan origination fees.

Total program administration expenses decreased by \$2.3 million from \$18.2 million for the year ended June 30, 2009 to \$15.9 million for the year ended June 30, 2010. This is due to a decrease of payroll and other support expenditures.

## ***OVERVIEW OF LOAN PORTFOLIO***

### ***Single Family Home Loans***

The Department makes loans to veterans for the purchase of individual residences. Approximately 89% of the dollar volume of the Department's loans are for home loans as of June 30, 2010. Currently the maximum loan amount is \$521,250 which represents 125% of the maximum loan limit for a single-family home set by the Federal National Mortgage Association ("Fannie Mae").

Loans are made after an underwriting process that includes, but is not limited to: a review of credit history, verifiable income and the amount and source of down payment. In general, credit scores of approved applicants are above the average. Loans with an initial loan to value (LTV) of greater than 80% are required to be insured, either through private mortgage insurance or through the guarantee program of the United States Department of Veterans Affairs (USDVA). Loans with a LTV of 97% or greater are required to be insured through the USDVA guaranty program. Under the USDVA guarantee program, the Department is insured for the first 25% of loss in the event that they are required to foreclose on a property and need to sell that property for less than the outstanding loan balance.

Interest rates for loans are determined when the loan is originated. As of June 30, 2010, interest rates on loans outstanding ranged from 4.25% to 9.75%. While the Department has the limited ability to adjust the interest rates, post-1999 loans can be adjusted by 0.5% if needed and pre-1999 loans can be adjusted with no rate cap, the policy of the Department has been to leave the interest rate fixed at the rate in effect when the loan was originated.

### ***Mobile Homes***

The Department makes loans to veterans for the purchase of mobile homes. Approximately 7% of the dollar volume of the Department's loans are for home loans as of June 30, 2010. Currently the maximum loan amount is \$175,000. The terms of the loans for mobile homes are substantially the same as loans made to finance the purchase of single-family homes. In certain circumstances, the interest rate of a mobile home loan may be 1% higher than an equivalent loan on a single family home.

### ***Construction or Home Improvement Loans***

The Department makes a limited amount of construction or home improvement loans. These loans typically have a LTV of lower than 90%. The Department did not have a significant amount of construction or home improvement loans outstanding at June 30, 2010.

### ***ALLOWANCES FOR UNCOLLECTIBLE LOANS AND LOSSES ON OTHER REAL ESTATE OWNED***

The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectability and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation. Management updates its estimates periodically to take into account changes in the economic environment. The allowance for uncollectible contracts was \$16,543,000 and \$13,927,000 as of June 30, 2010 and 2009, respectively.

***Other Real Estate Owned*** — Real estate acquired by the Fund by repossession is recorded at the lower of estimated fair value less estimated selling costs (fair value) or the carrying value of the related loan at the date of foreclosure. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses. Operating costs on foreclosed real estate are expensed as incurred. Costs incurred for physical improvements to foreclosed real estate are capitalized if the value is recoverable through future sale.

### ***Higher-Risk Loans***

The Departments higher risk loans, designated by having a loan-to-value ratio of 97% or greater, are evenly dispersed throughout the state. The loan to value ratio was determined by dividing the current loan balance by the initial purchase price of the property. Out of our 10,801 loan portfolio (not including Home Improvement Loans) only 6.4% of those loans were determined to have a high loan-to-value ratio. The highest concentration of those loans was in San Diego County with these loans representing less than 1% of the Department's total portfolio. Reducing the risk of many of the loans in the portfolio is the fact that 99.8% of the high loan-to-value loans in the Department's portfolio are currently insured with USDVA leaving only 0.2% of the total portfolio being uninsured and having a high loan-to-value ratio.

### *Mitigating Market Factors*

The following features of the Program are designed to mitigate and protect the Program from the negative effects of market downturns:

- The Department does not provide variable rate loans.
- The Department requires that, at the time of financing, Program participants reside in the home purchased under the Contracts of Purchase.
- The Department's underwriting requirements, according to an internal unaudited survey by the Department, have resulted in an average borrower FICO credit score in excess of 700 for transactions originated during the last five years.
- Certain of the Department's Contracts of Purchase are guaranteed through the USDVA guaranty program. See "THE PROGRAM – USDVA Guaranty Program; Loan Insurance."
- Since 2009, all new Contracts of Purchase require a minimum 1.25% funding fee.

The Department cannot predict whether disruptions in the housing and financial markets generally or difficulties in the national or California economies will continue and, if so, whether the Department's finances will be adversely impacted.

### **Economic Factors Facing Veterans Farm & Home Building Fund of 1943**

At June 30, 2010, the Program's loan portfolio balance was at approximately \$1.500 billion, a decrease of \$188 million, or 11.1%, from \$1.688 billion at June 30, 2009. During the fiscal year, cash and investments balance decreased \$38 million, or 11.8%, from a balance of \$322 million to \$284 million. Bonds payable decreased \$185 million, or 10%, from \$1.852 billion at June 30, 2009 to \$1.667 billion at June 30, 2010. Bond ratings for the Department's GO bonds are AA, A1 and AA- by rating agencies Standard & Poor's, Moody's and Fitch, respectively. Bond ratings for the Department's Revenue bonds are AA-, Aa2 and AA- by Standard & Poor's, Moody's and Fitch, respectively.

### ***Department Outlook***

The ability of the Department to return to an excess of revenues over expenses in future periods and the financial performance of the 1943 Fund depends upon a variety of factors including, among others: (a) the level of interest rates available on short-term investments (including the rate paid on the SMIF and investment contracts as such contracts may be acquired) relative to the level of interest rates on outstanding Veterans G.O Bonds and Revenue Bonds; (b) the rate of origination and the rate of prepayment of Contracts of Purchase, which will directly affect the amount of bond proceeds, recycling funds and revenues held in such investments; (c) the interest rates established from time to time by the Department for newly originated Contracts of Purchase relative to the interest cost on bonds issued to finance such Contracts of Purchase; (d) the interest rates on outstanding Contracts of Purchase relative to the interest cost on outstanding bonds; (e) the Department's ability to use special and optional redemption provisions to minimize the overall cost of outstanding debt; (f) the market prices that can be achieved upon the sale of repossessed properties relative to the then-outstanding Contract of Purchase balances; (g) the level of administrative expenses relative to the rate of origination and outstanding balances of the Contracts of Purchase; (h) counter-party performance under the Department's investment agreements; (i) uncertainties, disruption or volatility in the financial markets, generally, and in the mortgage and residential real estate markets, specifically; (j) the accuracy of certain projections and assumptions upon which the Department's financial planning may be based, including, among other things, the rate of repayment of Contracts of Purchase, levels of defaults and delinquencies and losses on Contracts of Purchase; (k) the issuance and structuring of any additional Veterans G.O. Bonds or Revenue Bonds; (l) the implementation of any new programs of the Department; and (m) changes in law, including

changes which may affect the timing and the amount the Department may recover from Contracts of Purchase. The Department expects that there will be significant variations in results in future periods, including additional periods in which there may be a deficit of revenues over expenses.

## Fiscal Year 2009 Compared to Fiscal Year 2008

### Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2009 and June 30, 2008 (dollars in thousands) and the percentage change.

	2009	2008	Change	% Change
<b>ASSETS</b>				
Cash, cash equivalents and investments	\$ 322,507	\$ 566,111	\$ (243,604)	(43.0)%
Receivables under contracts of purchase—net	1,688,016	1,664,908	23,108	1.4 %
Other receivables and assets	<u>70,501</u>	<u>59,282</u>	<u>11,219</u>	18.9 %
TOTAL ASSETS	<u>\$ 2,081,024</u>	<u>\$ 2,290,301</u>	<u>\$ (209,277)</u>	(9.1)%
<b>LIABILITIES AND FUND EQUITY</b>				
Liabilities:				
Bonds payable	\$ 1,852,512	\$ 2,035,092	\$ (182,580)	(9.0)%
Other payables and liabilities	<u>28,905</u>	<u>33,346</u>	<u>(4,441)</u>	(13.3)%
Total liabilities	1,881,417	2,068,438	(187,021)	(9.0)%
Fund Equity	<u>199,607</u>	<u>221,863</u>	<u>(22,256)</u>	(10.0)%
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 2,081,024</u>	<u>\$ 2,290,301</u>	<u>\$ (209,277)</u>	(9.1)%

### *Assets*

Total assets decreased by \$209.3 million from \$2.290 billion at June 30, 2008 to \$2.081 billion at June 30, 2009. This decrease consisted primarily of the following items:

- Total cash, cash equivalents and investments decreased by \$244 million from \$566 million at June 30, 2008 to \$322 million at June 30, 2009. The decrease is a principally due to excess proceeds bond calls and significantly lower interest on investments.
- Net receivables under contracts of purchase increased by \$23.1 million from \$1.665 billion at June 30, 2008 to \$1.688 billion at June 30, 2009. The change was due to new contracts with larger loan amounts than average in the portfolio.
- All other receivables and assets increased by \$11.2 million from \$59.3 million at June 30, 2008 to \$70.5 million at June 30, 2009.

### *Liabilities and Fund Equity*

Total liabilities decreased by \$187 million from \$2.068 billion at June 30, 2008 to \$1.881 billion at June 30, 2009, principally due to excess proceeds bond calls.

Fund equity decreased by \$22.3 million from \$221.9 million at June 30, 2008 to \$199.6 million at June 30, 2009, as a result of unfavorable holding costs of cash assets, less revenue due to fewer loans processed and increased reserves for future REO losses.

The total assets to liability ratio remained unchanged at 1.11 as of June 30, 2009 and June 30, 2008.

## Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2009 and June 30, 2008 (dollars in thousands) and the percentage change.

	2009	2008	Change	% Change
<b>PROGRAM OPERATIONS:</b>				
Interest revenues:				
Contracts of purchase	\$ 99,058	\$ 93,234	\$ 5,824	6.2 %
Investments and other	<u>12,261</u>	<u>29,492</u>	<u>(17,231)</u>	(58.4)%
Total program operating revenues	111,319	122,726	(11,407)	(9.3)%
Expenses:				
Interest expense	103,043	108,211	(5,168)	(4.8)%
Change in allowance for uncollectible contracts	<u>11,293</u>	<u>2,115</u>	<u>9,178</u>	433.9 %
Total program operating expenses	<u>114,336</u>	<u>110,326</u>	<u>4,010</u>	3.6 %
Excess of program operations revenues over program operations expenses	<u>(3,017)</u>	<u>12,400</u>	<u>(15,417)</u>	(124.3)%
<b>PROGRAM ADMINISTRATION:</b>				
Total program administration revenues	2,475	2,053	422	20.6 %
Total program administration expenses	<u>18,246</u>	<u>17,274</u>	<u>972</u>	5.6 %
Excess of program administration expenses over program administration revenues	<u>(15,771)</u>	<u>(15,221)</u>	<u>(550)</u>	3.6 %
Operations excess (deficiency) of revenues over (under) expenses	(18,788)	(2,821)	(15,967)	566.0 %
(Loss) gain on sale of repossessed property	<u>(3,468)</u>	<u>(962)</u>	<u>(2,506)</u>	260.5 %
(Deficiency) excess of revenues (under) over expenses	<u>\$ (22,256)</u>	<u>\$ (3,783)</u>	<u>\$ (18,473)</u>	488.3 %

### *Program Operations*

Program operations revenues in excess of program operations expenses decreased \$15.4 million from \$12.4 million compared to a deficiency of \$3.0 million for the fiscal year ended June 30, 2008 and 2009, respectively, due to the following:

- Interest revenue from contracts of purchase increased by \$5.8 million from \$93.2 million for the year ended June 30, 2008 to \$99.1 million for the year ended June 30, 2009, due to the replacement of lower rate contracts with new contracts with larger loan amounts at higher interest rates.
- Interest revenues on investments decreased by \$17.2 million from \$29.5 million for the year ended June 30, 2008 to \$12.3 million for the year ended June 30, 2009. This decrease is due to the SMIF quarterly interest rate decreasing over the fiscal year from 3.11% at June 30, 2008 to 1.51% at June 30, 2009 combined with a decrease in the cash, cash equivalents and investments during that time.
- Net program operation expenses increased \$4.0 million from \$110.3 million for the year ended June 30, 2008 to \$114.3 million for the year ended June 30, 2009. The increase is due to a decrease of \$5.2 million in interest expense related to a decrease in bonds outstanding and a \$9.2 million increase in the allowance for uncollectible contracts of purchase.

### ***Program Administration***

Total program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance and premiums collected by the department for the fire and hazard insurance program. Total program administration revenues increased by \$0.4 million from \$2.1 million for the year ended June 30, 2008 to \$2.5 million for the year ended June 30, 2009, due to the following:

- The fire and hazard insurance program experienced an increase in net revenues of \$2.8 million due to fewer claimed losses during the fiscal year.
- Other income decreased by \$1.6 million, offset by a decrease of \$0.8 million related to loan origination fees.

Total program administration expenses increased by \$1.0 million from \$17.3 million for the year ended June 30, 2008 to \$18.3 million for the year ended June 30, 2009. The increase is due to an increase of payroll and other support expenditures related to the increase of staff and expenses related to work on delinquencies and REO's.

The sale of repossessed properties resulted in a loss of \$3.5 million for the year ended June 30, 2009 compared to a loss of \$1.0 million for the year ended June 30, 2008 due to a reduction in property values from loans made in the calendar years 2005, 2006 and 2007. The Funds' holdings of repossessed properties, net of allowances for losses increased from \$10.6 million as of June 30, 2008 to \$23.0 million as of June 30, 2009.

### ***OVERVIEW OF LOAN PORTFOLIO***

#### ***Single Family Home Loans***

The Department makes loans to veterans for the purchase of individual residences. Approximately 99.9% of the dollar volume of the Department's loans are for home loans as of June 30, 2009. Currently the maximum loan amount is \$521,250 which represents 125% of the maximum loan limit for a single-family home set by the Federal National Mortgage Association ("Fannie Mae").

Loans are made after an underwriting process that includes, but is not limited to: a review of credit history, verifiable income and the amount and source of down payment. In general credit scores of approved applicants are above the average. Loans with an initial loan to value (LTV) of greater than 80% are required to be insured, either through private mortgage insurance or through the guarantee program of the United States Department of Veterans Affairs (USDVA). Loans with a LTV of 97% or greater are required to be insured through the USDVA guaranty program. Under the USDVA guarantee program, the Department is insured for the first 25% of loss in the event that they are required to foreclose on a property and need to sell that property for less than the outstanding loan balance.

Interest rates for loans are determined when the loan is originated. As of June 30, 2009, interest rates on loans outstanding ranged from 9.75% to 4.25%. While the Department has the limited ability to adjust the interest rates, post-1999 loans can be adjusted by 0.5% if needed and pre-1999 loans can be adjusted with no rate cap, the policy of the Department has been to leave the interest rate fixed at the rate in effect when the loan was originated.

#### ***Mobile Homes***

The Department makes loans to veterans for the purchase of mobile homes. Approximately 7% of the dollar volume of the Department's loans are for home loans as of June 30, 2009. Currently the maximum

loan amount is \$175,000. The terms of the loans for mobile homes are substantially the same as loans made to finance the purchase of single family homes. In certain circumstances the interest rate of a mobile home loan may be 1% higher than an equivalent loan on a single family home.

### ***Construction or Home Improvement Loans***

The Department makes a limited amount of construction or home improvement loans. These loans typically have a LTV of lower than 90%. The Department did not have a significant amount of construction or home improvement loans outstanding at June 30, 2009.

### ***ALLOWANCES FOR UNCOLLECTIBLE LOANS AND LOSSES ON OTHER REAL ESTATE OWNED***

The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectability and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation. Management updates its estimates periodically to take into account changes in the economic environment. The allowance for uncollectible contracts was \$13,927,000 and \$9,743,000 as of June 30, 2009 and 2008, respectively.

***Other Real Estate Owned*** — Real estate acquired by the Fund by repossession is recorded at the lower of estimated fair value less estimated selling costs (fair value) or the carrying value of the related loan at the date of foreclosure. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses. Operating costs on foreclosed real estate are expensed as incurred. Costs incurred for physical improvements to foreclosed real estate are capitalized if the value is recoverable through future sale.

### ***Higher-Risk Loans***

The Departments higher risk loans, designated by having a loan-to-value ratio of 97% or greater, are evenly dispersed throughout the state. The loan to value ratio was determined by dividing the current loan balance by the initial purchase price of the property. Out of our 11,763 loan portfolio (not including Home Improvement Loans) only 7.8% of those loans were determined to have a high loan-to-value ratio. The highest concentration of those loans was in San Diego County with these loans representing less than 1% of the Department's total portfolio. Reducing the risk of many of the loans in the portfolio is the fact that 98% of the high loan-to-value loans in the Department's portfolio are currently insured with USDVA leaving only 0.16% of the total portfolio being uninsured and having a high loan-to-value ratio.

### ***Changes in Practices***

Due to the current economic market norms and the high percentage of Mobil Home REO's, the Department has revised its Mobile Home policy to include the following provisions:

- New Singlewide units may be financed for up to a maximum term of 15 years
  - Required down payment amount is 15%

- Used Singlewide units – no financing available
- New Multiwide units may be financed for up to a maximum term of 20 years
  - Required down payment amount is 10%
- Used Multiwide units may be financed for up to a maximum term of 20 years or the economic life expectancy, whichever is less.
  - Required down payment amount is 15%
- CalVet will not finance mobile homes that are over 20 years old

### **Economic Factors Facing Veterans Farm & Home Building Fund of 1943**

At June 30, 2009, the Program's loan portfolio balance was at approximately \$1.688 billion, an increase of \$23 million, or 1.4%, from \$1.665 billion at June 30, 2008. During the fiscal year, cash and investments balance decreased \$244 million, or 43.0%, from a balance of \$566 million to \$322 million. Bonds payable decreased \$183 million, or 9.0%, from \$2.035 billion at June 30, 2008 to \$1.852 billion at June 30, 2009. Bond ratings for the Department's GO bonds are AA-, A1 and A+ by rating agencies Standard & Poor's, Moody's and Fitch, respectively. Bond ratings for the Department's Revenue bonds are AA-, Aa2 and AA- by Standard & Poor's, Moody's and Fitch, respectively.

The passage of the HR6081 *Heroes Earnings Assistance and Relief Tax Act of 2008* and HR3221 *Housing and Economic Recovery Act of 2008* has dramatically increased the number of veterans eligible to apply to CalVet for housing loans and makes future bond issues exempt from the alternative minimum tax calculation.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**BALANCE SHEETS  
JUNE 30, 2010 AND 2009  
(In thousands)**

	<b>2010</b>	<b>2009</b>
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents:		
Cash in state treasury	\$ 16,586	\$ 19,590
SMIF	<u>224,418</u>	<u>266,551</u>
Total cash and cash equivalents	<u>241,004</u>	<u>286,141</u>
Current portion of receivables under contracts of purchase — net of allowance for uncollectible contracts	<u>43,154</u>	<u>46,923</u>
Interest receivables:		
Contracts of purchase	10,637	10,557
State of California's Surplus Money Investment Fund	272	1,122
Other investments	<u>304</u>	<u>131</u>
Total interest receivables	<u>11,213</u>	<u>11,810</u>
Total current assets	<u>295,371</u>	<u>344,874</u>
NONCURRENT ASSETS:		
Investments:		
GICs	36,701	29,776
Insurance administrators	<u>6,650</u>	<u>6,590</u>
Total investments	43,351	36,366
Receivables under contracts of purchase — net of allowance for uncollectible contracts	1,456,784	1,641,093
Due from Veterans Debenture Revenue Fund	28,753	32,089
Other real estate owned — net of allowance for losses of \$10,993 and \$9,103 in 2010 and 2009, respectively	23,272	22,996
Land, improvements, and equipment — net of accumulated depreciation of \$15,798 and \$15,761 in 2010 and 2009, respectively	505	532
Other noncurrent assets	<u>4,022</u>	<u>3,074</u>
Total noncurrent assets	<u>1,556,687</u>	<u>1,736,150</u>
<b>TOTAL</b>	<b><u>\$1,852,058</u></b>	<b><u>\$2,081,024</u></b>
<b>LIABILITIES AND FUND EQUITY</b>		
CURRENT LIABILITIES:		
Bonds payable — current portion	\$ 33,940	\$ 67,025
Accrued interest and other liabilities	19,830	22,654
Due to other funds	(6)	(148)
Fire and hazard insurance claims payable	<u>875</u>	<u>428</u>
Total current liabilities	<u>54,639</u>	<u>89,959</u>
NONCURRENT LIABILITIES:		
Bonds payable — noncurrent portion	1,633,314	1,785,487
Other postemployment benefits	675	481
Self-insured life and disability insurance loss reserve	<u>1,711</u>	<u>5,490</u>
Total noncurrent liabilities	<u>1,635,700</u>	<u>1,791,458</u>
Total liabilities	<u>1,690,339</u>	<u>1,881,417</u>
COMMITMENTS AND CONTINGENCIES (Note 9)		
FUND EQUITY — Unrestricted	<u>161,719</u>	<u>199,607</u>
<b>TOTAL</b>	<b><u>\$1,852,058</u></b>	<b><u>\$2,081,024</u></b>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY  
YEARS ENDED JUNE 30, 2010 AND 2009**

**(In thousands)**

	<b>2010</b>	<b>2009</b>
<b>PROGRAM OPERATIONS:</b>		
Interest revenues:		
Contracts of purchase of properties	\$ 91,222	\$ 99,058
Investments and other	3,595	10,783
Transfers of revenues from Veterans Debenture Revenue Fund	<u>1,365</u>	<u>1,478</u>
Total revenues	<u>96,182</u>	<u>111,319</u>
Expenses:		
Interest expense	89,519	103,043
Provision for program loan losses	<u>19,575</u>	<u>11,293</u>
Total expenses	<u>109,094</u>	<u>114,336</u>
Deficiency of program operations revenue under program operations expenses	<u>(12,912)</u>	<u>(3,017)</u>
<b>PROGRAM ADMINISTRATION:</b>		
Revenues:		
Loan fees	785	2,158
Other revenue (expense)	1,145	(869)
Net revenue — fire and hazard insurance program	1,303	1,647
Net revenue (expense) — self-insured life and disability insurance program	<u>592</u>	<u>(461)</u>
Total revenues	<u>3,825</u>	<u>2,475</u>
Expenses:		
Payroll and related costs	8,343	9,732
General and administrative expenses	<u>7,558</u>	<u>8,514</u>
Total expenses	<u>15,901</u>	<u>18,246</u>
Deficiency of program administration revenues under program administration expenses	<u>(12,076)</u>	<u>(15,771)</u>
OPERATIONS DEFICIENCY OF REVENUES UNDER EXPENSES	(24,988)	(18,788)
NONOPERATING REVENUE — Loss on sale of repossessed property	<u>(12,900)</u>	<u>(3,468)</u>
Deficiency of revenues under expenses	(37,888)	(22,256)
<b>FUND EQUITY:</b>		
Beginning of year	<u>199,607</u>	<u>221,863</u>
End of year	<u>\$ 161,719</u>	<u>\$ 199,607</u>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF CASH FLOWS  
YEARS ENDED JUNE 30, 2010 AND 2009  
(In thousands)**

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from contract holders	\$ 5,095	\$ 7,190
Interest received	95,414	111,135
Interest payments	(89,519)	(103,043)
Payments to suppliers and employees	(18,189)	(20,340)
Other payments	(1,370)	(19,218)
	<u>(8,569)</u>	<u>(24,276)</u>
Net cash used in operating activities		
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Proceeds from sales of bonds payable	118,710	
Maturities of bonds payable	(63,405)	(97,015)
Early redemption of bonds payable	(242,785)	(87,955)
Increase to deferred finance costs	(1,032)	
Net decrease in due from Veterans Debenture Revenue Fund	3,336	43
	<u>(185,176)</u>	<u>(184,927)</u>
Net cash used in noncapital financing activities		
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease (increase) in receivables under contracts of purchase	155,603	(34,401)
Increase in guaranteed investment contracts	(6,985)	(4,121)
Purchase of land, improvements, and equipment	(10)	
	<u>148,608</u>	<u>(38,522)</u>
Net cash provided by (used in) investing activities		
DECREASE IN CASH AND CASH EQUIVALENTS		
	(45,137)	(247,725)
CASH AND CASH EQUIVALENTS:		
Beginning of year	<u>286,141</u>	<u>533,866</u>
End of year	<u>\$ 241,004</u>	<u>\$ 286,141</u>
RECONCILIATION OF (DEFICIENCY) EXCESS OF REVENUES (UNDER) OVER EXPENSES TO NET CASH USED IN OPERATING ACTIVITIES:		
Deficiency of revenues under expenses	\$ (37,888)	\$ (22,256)
Adjustments to reconcile deficiency of revenues under expenses to net cash used in operating activities:		
Bond amortization	3,254	2,390
Change in allowance for uncollectible contracts	19,575	11,293
Depreciation	37	38
Loss on sale of repossessed property	12,900	3,468
Effect of changes in assets and liabilities:		
Decrease in interest receivable — State of California's Surplus Money Investment Fund	850	3,145
Increase in interest receivable — other investments	(173)	(6)
Increase in interest receivable — contracts of purchase	(80)	(1,845)
Increase in other real estate owned	(276)	(15,839)
Increase in other assets	(948)	(223)
Decrease in accrued interest and other liabilities	(2,824)	(1,517)
Increase (decrease) in due to other funds	142	(734)
Increase in other postretirement benefits	194	157
Increase (decrease) in fire and hazard insurance claims payable	447	(1,076)
Decrease in self-insured life and disability insurance loss reserve	(3,779)	(1,271)
	<u>(8,569)</u>	<u>(24,276)</u>
NET CASH USED IN OPERATING ACTIVITIES		

See notes to financial statements.

# VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

## NOTES TO FINANCIAL STATEMENTS YEARS ENDED JUNE 30, 2010 AND 2009

---

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Organization and Description** — The California Department of Veterans Affairs (the “Department”) is a separate legal entity and a cabinet-level agency of the state of California. A seven-member California Veterans Board (the “Board”) has policy oversight of the operations of the Department, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the “Fund”) was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the legislature are used for contract loans to veterans. Expenses are primarily for debt service and administration of the program. The Fund is tax exempt.

The financial statements represent only the activities of the Fund and are not intended to present the financial position of the Department and the results of its operations and its cash flows of its proprietary funds. The financial statements of the Fund are included in the financial statements of the state of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

**Basis of Accounting** — The Fund has been classified as a proprietary fund for accounting purposes. Revenues are recorded when earned and expenses are recognized as incurred.

**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, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, which allows the Fund to apply all GASB pronouncements and only Financial Accounting Standards Board (FASB) pronouncements which date prior to November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: FASB statements and interpretations, Accounting Principles Board opinions, and Accounting Research Bulletins of the committee on accounting procedures.

**Use of Estimates in the Preparation of Financial Statements** — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 from those estimates.

**Cash and Cash Equivalents** — The Fund considers all cash and highly liquid investments purchased with original maturities of three months or less to be cash and cash equivalents. At June 30, 2010 and 2009, cash equivalents consisted of the State of California’s Surplus Money Investment Fund (SMIF), carried at cost, which approximates fair value.

**Investments** — The Department reports all investments at fair value except for certain nonparticipating fixed-interest investment contracts, which are valued at cost. The fair value of investments is based on published market prices and quotations from major investment brokers. Uncommitted bond proceeds for loans to veterans are reflected in the balance sheets within the investments balance.

**Receivables Under Contracts of Purchase** — Receivables under contracts of purchase consist of the remaining contract principal balance net of the allowance for uncollectible contracts.

**Revenue Recognition** — Interest is recognized as revenue when earned according to the terms of the loans. Interest accrual is only discontinued at the point of physical property repossession.

**Allowance for Uncollectible Contracts** — The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectibility and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation. The allowance for uncollectible contracts was \$16,543,000 and \$13,927,000 as of June 30, 2010 and 2009, respectively.

**Contract Guarantees and Primary Mortgage Insurance** — The Department collects a contract guarantee fee on all contracts with down payments less than 20% of purchase price. Such contracts are classified as high loan to value (HLTV) contracts. For eligible borrowers, the fee is used to purchase contract guarantees from the U.S. Department of Veterans Affairs (USDVA) or primary mortgage insurance (PMI). Prior to March 31, 2008, for certain HLTV contracts not eligible for USDVA guarantees, the Fund purchased PMI from Radian Guaranty Inc., formerly, the Commonwealth Mortgage Assurance Company. The PMI provides lifetime coverage on the HLTV contracts, not covered by USDVA guarantees, subject to an aggregate 2% deductible. The Department is responsible for any losses not covered by the USDVA guarantees or the PMI.

**Other Real Estate Owned** — Real estate acquired by the Fund by repossession is recorded at the lower of estimated fair value, less estimated selling costs (fair value) or the carrying value of the related loan at the date of foreclosure. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses. Operating costs on foreclosed real estate are expensed as incurred. Costs incurred for physical improvements to foreclosed real estate are capitalized if the value is recoverable through future sale.

**Fire and Hazard Insurance Plan** — This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred is included as a net amount in the statements of revenues, expenses, and changes in fund equity. Fire and hazard insurance claims payable include unpaid claims and incurred but not reported claims.

**Self-Insured Life and Disability Insurance Plan** — Beginning in 1984, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. This plan was terminated on June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan, which include future disability and life benefits were derived from an

actuarial evaluation performed in 2006 that is updated internally on an annual basis. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability, prepayment, and a long-term discount rate of 7%. Self-insured life and disability insurance loss reserve include unpaid claims, incurred but not reported claims and loss reserve.

**Amortization of Bond Premiums, Discounts, and Issuance Costs** — Premiums and discounts arising from the issuance of bonds and expenses incurred in connection with the issuance of bonds are capitalized and amortized using the monthly amortization method, which approximates the interest method.

**New Accounting Standard** — GASB issued a statement for future reporting periods. In June 2008, the GASB issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, effective for the period beginning after June 15, 2009, with earlier application encouraged. GASB Statement No. 53 addresses the recognition, measurement, and disclosure of information regarding derivative instruments. The adoption of this statement did not have a material impact on the financial statements, as the Fund currently does not hold any derivative instruments.

## 2. CASH, CASH EQUIVALENTS, AND INVESTMENTS

**Cash in State Treasury** — Cash in the state treasury represents amounts held in the Fund's general operating accounts with the state treasury. These monies are pooled with the monies of other state agencies and invested by the state treasurer's office. These assets are not individually identifiable. At June 30, 2010 and 2009, the carrying amount of the Fund's deposits in state treasury was \$16,586,000 and \$19,590,000, respectively.

**SMIF** — Cash in the SMIF represents the value of the deposits in the state treasurer's pooled investment program, which is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2010 and 2009, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value. For a complete description of the risks related to this program, refer to the state of California Comprehensive Annual Financial Report (CAFR) that includes information about the state's pooled investment program. At June 30, 2010 and 2009, the carrying amount of the Fund's deposits in SMIF was \$224,418,000 and \$266,551,000, respectively.

**Investments** — Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments. These investments include direct obligations of the U.S. government and its agencies and investment agreements with financial institutions or insurance companies rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, are authorized by California law. The Department monitors the creditworthiness of all companies that hold investments of the Fund.

The Fund's investment in nonparticipating fixed-interest contracts, carried at cost, was \$36,701,000 and \$29,776,000 as of June 30, 2010 and 2009, respectively. The interest rates on investment agreements are fixed and range from 5.30% to 6.46%. The investment agreements expire from 2010 to 2032.

**Investment Risk Factors** — Many factors 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 factors such as economic conditions, individual company earnings 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 within SMIF and the remainder in investment contracts or with insurance administrators to limit the Fund’s exposure to most types of investment risk.

*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 June 30, 2010 and 2009, the Fund does not have significant 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 June 30, 2010 and 2009, 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 June 30, 2010 and 2009, the Fund does not have a significant 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 June 30, 2010 and 2009, the Fund does not have any significant debt investments that are highly sensitive to changes in interest rates.

The Fund’s investments include amounts held in trust fund with insurance administrators and various guaranteed investment contracts (GICs) with insurance companies. The GICs are collateralized by investments held by the state of California on behalf of the Fund. Additionally, the Fund only invests in investment agreements issued by highly rated insurance companies, and management regularly monitors the credit rating of the insurance companies issuing such investment agreements as part of monitoring the Fund’s exposure to credit risk.

The Fund’s investments as of June 30, 2010 and 2009, are as follows (in thousands):

	<b>2010</b>	<b>2009</b>
Investment agreements (at cost)	\$ 36,701	\$ 29,776
Amounts held in trust fund with insurance administrators	<u>6,650</u>	<u>6,590</u>
Total investment	<u>\$ 43,351</u>	<u>\$ 36,366</u>

### 3. RECEIVABLES UNDER CONTRACTS OF PURCHASE

The Fund retains title to all real property subject to contracts of purchase until the contract is satisfied. The veterans' contracts have original terms of 25–30 years and bear interest at rates of 4.25%–9.75%, depending on the age and type of contract and the classification of the contract holder. Receivables under contracts of purchase, net of allowance for uncollectible contracts as of June 30, 2010 and 2009, were as follows (in thousands):

	<b>2010</b>	<b>2009</b>
Receivables under contracts of purchase	\$ 1,516,481	\$ 1,701,943
Less allowance for uncollectible contracts of purchase	<u>(16,543)</u>	<u>(13,927)</u>
Total	1,499,938	1,688,016
Less current portion	<u>(43,154)</u>	<u>(46,923)</u>
Receivables under contracts of purchase — net	<u>\$ 1,456,784</u>	<u>\$ 1,641,093</u>

### 4. LAND, IMPROVEMENTS, AND EQUIPMENT

Land, improvements, and equipment as of June 30, 2010 and 2009, consisted of the following (in thousands):

	<b>2010</b>	<b>2009</b>
Land	\$ 443	\$ 443
Buildings	12,410	12,410
Equipment	<u>3,450</u>	<u>3,440</u>
Total	16,303	16,293
Less accumulated depreciation	<u>(15,798)</u>	<u>(15,761)</u>
Land, improvements, and equipment — net	<u>\$ 505</u>	<u>\$ 532</u>

## 5. BONDS PAYABLE

Bonds payable as of June 30, 2010 and 2009, included the following (in thousands):

	2010	2009
General obligation bonds of the state of California, fixed annual interest rates from 2.2% to 9.8% due in varying annual installments through 2042 (subject to varying redemption provisions)	\$ 1,002,225	\$ 1,172,330
Home purchase revenue bonds, fixed annual interest rates from 4.6% to 5.5%, due in varying annual installments through 2042 (subject to varying redemption provisions)	<u>677,430</u>	<u>694,805</u>
Total	1,679,655	1,867,135
Less:		
Discounts	(1,618)	(1,913)
Premium	247	257
Unamortized bond origination costs	(10,331)	(12,029)
Unamortized bond redemption premiums	<u>(699)</u>	<u>(938)</u>
Total	1,667,254	1,852,512
Less — current portion	<u>33,940</u>	<u>67,025</u>
Noncurrent portion	<u>\$ 1,633,314</u>	<u>\$ 1,785,487</u>

A summary of debt service requirements for the next five years and to maturity as of June 30, 2010, is as follows (in thousands):

Fiscal Years Ending June 30	Principal	Interest
2011	\$ 33,940	\$ 77,568
2012	47,925	75,688
2013	32,940	74,253
2014	54,745	72,827
2015	28,355	71,504
2016–2020	251,640	334,819
2021–2025	396,700	252,894
2026–2030	411,270	147,067
2031–2035	249,590	67,684
2036–2040	135,170	23,494
2041–2045	<u>37,380</u>	<u>2,073</u>
Total	<u>\$ 1,679,655</u>	<u>\$ 1,199,871</u>

General obligation bonds of the state of California are payable in accordance with the various veterans bond acts by the state general fund. The full faith and credit of the state of California is pledged for the payment of both principal and interest. All general obligation bonds have an equal claim against the general fund of the state of California. These bonds are included as obligations of the Fund when the

proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. The authorized and unissued bonds under the Veterans Bond Act of 2000 were \$238,610,000 at June 30, 2010, and \$263,610,000 at June 30, 2009. In November 2008, California voters approved the Veterans Bond Act of 2008 ("2008 Bond Act") totaling \$900,000,000. As of June 30, 2010 and 2009, no bonds have been issued under the 2008 Bond Act.

Home purchase revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Fund and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the Fund is secondary and subordinate to any interest or right in the Fund of the people of the state of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the \$1.5 billion ceiling authorized in 1987, less revenue bonds outstanding at that time. At June 30, 2010 and 2009, authorized and unissued revenue bonds were \$822,570,000 and \$805,195,000, respectively.

During fiscal year 1998, the Department amended the revenue bond resolution provisions regarding the bond reserve account in the Veterans Debenture Revenue Fund (a separate entity). The revenue bond resolution requires the establishment and maintenance of a bond reserve account in an amount equal to at least 3% of the aggregate outstanding principal amount of all revenue bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A, B, and C Bonds, 1998 Series A Bonds, 1999 Series A and B Bonds, 2000 Series A, B, and C Bonds, and 2001 Series A Bonds), a requirement equal to at least 7% of the outstanding principal amount of such revenue bonds, and for Series 2002 an amount equal to 5% of the outstanding principal amount. Amounts in the bond reserve account shall be used solely for the purposes of paying the principal of and the interest on the revenue bonds and for making mandatory sinking fund account payments on revenue bonds. Amounts on deposit in the bond reserve account as of any date, in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Fund, at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund. At June 30, 2010 and 2009, the total assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the Department.

## **6. BOND REDEMPTION AND REFUNDING**

For the year ended June 30, 2010, the Department issued general obligation bonds totaling \$118,710,000 of which \$93,710,000 was used to refund certain outstanding general obligation bonds and \$25,000,000 was available to finance new and existing contracts of purchase. The Department did not issue either general obligation bonds or home purchase revenue bonds for the year ended June 30, 2009.

The Department redeemed \$13,755,000 for home purchase revenue bonds and \$131,700,000 for general obligation bonds, to pay off higher coupon debt prior to maturity. The Department also paid off \$57,035,000 of general obligation noncallable debt and \$6,370,000 of callable debt, due to maturity. Currently, the Department has no outstanding commercial paper.

## **7. FIRE AND HAZARD INSURANCE**

Fire and hazard insurance coverage is provided on behalf of contract holders for all of the single-family detached homes subject to the California Veterans contracts of sale. The program is funded by amounts charged to contract holders, which are considered appropriate to cover losses incurred, the premiums paid for excess insurance coverage, claims adjusting costs, and administration fees. From the amounts

charged to the contract holders, the Department pays losses up to a \$2,500,000 deductible, with an annual aggregate deductible of \$10,000,000. Several insurance carriers supply an additional \$50,000,000 of coverage in excess of these deductibles. The claims loss expense is based on our third-party administrator's estimate of incurred but not reported claims, which is based on the historical trends and loss experience within the portfolio.

The excess of premiums charged to contract holders over claims, expenses, and changes in loss reserves for the years ended June 30, 2010 and 2009, was as follows (in thousands):

	<b>2010</b>	<b>2009</b>
Amounts charged to contract holders	\$ 4,281	\$ 4,929
Less:		
Claims loss expense	(2,463)	(2,350)
Master policy premium	(636)	(722)
Administrative fees	(266)	(209)
Other — settlement	<u>387</u>	<u>          </u>
Net revenue — fire and hazard insurance program	<u>\$ 1,303</u>	<u>\$ 1,648</u>

#### **8. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN**

The Department was responsible for a self-insured life and disability protection plan for all contract holders until June 1, 1996. Except for existing contract holders receiving benefits at that date, the self-insured life and disability protection plan was replaced by existing life and disability insurance plan provided by commercial insurers.

As of June 30, 2010, the Department remains self-insured for approximately 70 remaining contract holders. Under the provisions of the self-insured plan, benefits continue until the beneficiary returns to active employment, dies, or his or her contract is paid off. Loss reserves for these obligations have been estimated by management based on its historical experience.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverage continues as obligations of the self-funded life and disability protection plan for the years ended June 30, 2010 and 2009, was as follows (in thousands):

	<b>2010</b>	<b>2009</b>
Claims expenses:		
Life insurance program	\$ (25)	\$ (166)
Disability insurance program	<u>(3,181)</u>	<u>(1,609)</u>
Total claims expenses	(3,206)	(1,775)
Decrease in estimated loss reserves	<u>3,779</u>	<u>1,271</u>
Net claims revenue and change in loss reserves	<u>573</u>	<u>(504)</u>
Plan revenues:		
Life insurance program	6	14
Disability insurance program	<u>22</u>	<u>48</u>
Total	28	62
Administrative fees	<u>(9)</u>	<u>(19)</u>
Net revenue (expense) — self-insured life and disability insurance program	<u>\$ 592</u>	<u>\$ (461)</u>

The change in the self-insured life and disability insurance loss reserve for the years ended June 30, 2010 and 2009, was as follows (in thousands):

	<b>2010</b>	<b>2009</b>
Self-insured life and disability insurance loss reserve — beginning of year balance	\$ 5,490	\$ 6,761
Insurance claims payable		
Change in estimated loss reserve	<u>(3,779)</u>	<u>(1,271)</u>
Self-insured life and disability insurance loss reserve — end of year balance	<u>\$ 1,711</u>	<u>\$ 5,490</u>

## 9. COMMITMENTS AND CONTINGENCIES

**Commitments** — As of June 30, 2010, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately \$8,119,000.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 2010 and 2009, was \$241,000 and \$237,000, respectively. Minimum annual rentals under operating leases as of June 30, 2010, are as follows (in thousands):

**Fiscal Years Ending  
June 30**

2011	\$ 48
2012	<u>25</u>
Total	<u>\$ 73</u>

**Contingencies** — The Fund is subject to a variety of legal actions arising out of the normal course of business. Based upon information available to the Fund, its review of such lawsuits and consultation with legal counsel, the Fund believes the liability relating to these actions, if any, would not have a material adverse effect on the Fund’s financial statements.

**10. EMPLOYEE BENEFIT PLANS**

**Public Employees’ Retirement Fund:**

*Plan Description* — 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 CAFR that includes financial statements and required supplementary information for the PERF. A copy of that report may be obtained from CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 95229-2715 or via the Internet at [www.calpers.ca.gov](http://www.calpers.ca.gov).

*Funding Policy* — Contributions to the Plan are funded by both the Department and the employee and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on 5% of compensation in excess of \$513 each month.

Contributions by the Department to the Plan for the years ended June 30, 2010 and 2009, were approximately \$851,000 and \$963,000, or approximately 14% and 14.3% of participants’ salaries, respectively.

*Annual Pension Cost* — For fiscal years June 30, 2010 and 2009, the Department’s annual pension cost was equal to the Department’s required and actual contributions. The required contribution is determined by actuarial valuation using the entry age normal actuarial cost method. The most recent actuarial valuation available is as of June 30, 2007, which actuarial assumptions included (a) 7.75% investment rate of return compounded annually, (b) projected salary increases that vary based on duration of service, and (c) overall payroll growth factor of 3.25% annually. Both (a) and (b) included an inflation component of 3.0% and a 0.25% per annum productivity increase assumption. The actuarial value of CalPERS assets attributable to the Department was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a two- to five-year period.

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, is presented in the June 30, 2008, CalPERS CAFR.

**State of California Other Postemployment Benefit Plan:**

*Plan Description* — The Fund contributes to the State of California Other Postemployment Benefit Plan (SCOPEB) as part of the state of California, the primary government. The SCOPEB is a cost-sharing multiple-employer defined benefit postemployment health care plan administered by the state of California and CalPERS. CalPERS provides retirement, death, disability, and postretirement health care benefits to members as established by state statute. CalPERS issues a publicly available CAFR that includes financial statements and required supplementary information for the SCOPEB. A copy of that report may be obtained from CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 95229-2715 or via the Internet at [www.calpers.ca.gov](http://www.calpers.ca.gov).

*Funding Policy* — The state controller’s office sets the employer contribution rate based on the annual required contribution (ARC) of the employers, an amount actuarially determined in accordance with the parameters of GASB Statement No. 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 30 years. The Fund’s estimated unfunded other postemployment benefit cost was \$675,000 and \$481,000 for the years ended June 30, 2010 and 2009, respectively. The Fund recognized \$194,000 and \$157,000 in expense for the years ended June 30, 2010 and 2009, respectively.

The Department has expensed the above amounts in the appropriate fiscal years and a reserve has been established to transfer to the state’s trust account once the account is established. The Department has fully funded its other postemployment benefit costs by setting aside 100% of the established amounts to fund this expense.

**11. SUBSEQUENT EVENTS**

On September 1, 2010, the Department voluntarily redeemed \$100 million of general obligation and \$25 million of revenue bonds.

On September 2, 2010, Moody’s Investor Services upgraded the Department’s general obligation bonds from A1 to Aa2 with a stable outlook.

On October 1, 2010, the Department paid off the remaining \$22,820,000 of noncallable debt; these bonds had an average coupon rate of 8.03%.

\* \* \* \* \*