

Management's Discussion and Analysis – Continued

CharterMac & Subsidiaries

imately \$5 million of the purchase price to the estimated future cash flows to be received from general partner interests in investment partnerships in which we maintain a non-equity controlling partner. However, from time to time the general partner of the investment funds, may be called upon to fund investment fund operations which we would advance on behalf of the general partner and would be repaid to us out of future operating cash flow or sale or refinancing proceeds received by the investment fund, so our maximum exposure to loss cannot be quantified. We also have exposure to losses under guarantees of returns on certain funds, as described in Note 16.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." This statement requires that certain financial instruments that have the characteristics of debt and equity be classified as debt. SFAS No. 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective at the beginning of the first interim period beginning after June 15, 2003. Pursuant to SFAS No. 150, on July 1, 2003 we have reclassified \$273.5 million previously shown in the "mezzanine" (between liabilities and equity) in the consolidated balance sheets as "preferred shares of subsidiary subject to mandatory redemption" into the liability section, and the dividends paid on such shares (approximately \$9.4 million for the year ended December 31, 2003) has been classified as interest expense; dividends related to prior periods continue to be classified as income allocated to preferred shareholders of subsidiary.

The following recent pronouncements had no material impact on our consolidated financial statements:

- SFAS No. 145 "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections".
- SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities".
- SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities".

Inflation

Inflation did not have a material effect on our results for the periods presented.

Quantitative and Qualitative Disclosures About Market Risk

We invest in certain financial instruments, primarily revenue bonds and other bond related investments that are subject to various forms of market risk, including real estate risk, interest rate risk, credit and liquidity risk and prepayment risk. We seek to

prudently and actively manage such risks to earn sufficient compensation to justify the undertaking of such risks and to maintain capital levels which are commensurate with the risks we undertake.

Real Estate Risk

We derive income by investing in revenue bonds secured by multi-family affordable residential properties. Investing in such revenue bonds collateralized by such properties subjects us to various types and degrees of risk that could adversely affect the value of our assets and our ability to generate revenue. The factors that may reduce our revenues, net income and cash available for distributions to shareholders include the following: the property securing a revenue bond may not generate income sufficient to meet its operating expenses and debt service on its related revenue bond; economic conditions, either local, regional or national, may limit the amount of rent that can be charged for rental units at the properties, and may result in a reduction in timely rent payments or a reduction in occupancy levels; occupancy and rent levels may be affected by construction of additional housing units and national, regional and local politics, including current or future rent stabilization and rent control laws and agreements; federal LIHTC and city, state and federal housing subsidy or similar programs which apply to many of the properties, could impose rent limitations and adversely affect the ability to increase rents to maintain the properties in proper condition during periods of rapid inflation or declining market value of such properties; and, if a revenue bond defaults, the value of the property securing such revenue bond (plus, for properties that have availed themselves of the federal LIHTC, the value of such credit) may be less than the face amount of such revenue bond.

All of these conditions and events may increase the possibility that a property owner may be unable to meet its obligations to us under its mortgage revenue bond. This could affect our net income and cash available for distribution to shareholders. We manage these risks through diligent and comprehensive underwriting, asset management and ongoing monitoring of loan performance.

We may be adversely affected by periods of economic or real estate downturns that result in declining property performance or property values. Any material decline in property values used as collateral for our revenue bonds increases the possibility of a loss in the event of default. Additionally, some of our income may come from additional interest received from the participation of a portion of the cash flow, sale or refinancing proceeds on Underlying Properties. The collection of such additional interest may decrease in periods of economic slowdown due to lower cash flows or values available from the properties. In a few instances, the revenue bonds are subordinated to the claims of other senior interest and uncertainties may exist as to a borrower's ability to meet principal and interest payments. Because of