

Management's Discussion and Analysis – Continued

CharterMac & Subsidiaries

recorded in earnings. There was no ineffectiveness in the hedging relationship during 2001, 2002 or 2003, and we expect that these hedging relationships will be highly effective in achieving offsetting changes in cash flow throughout their terms. Net amounts payable or receivable under the swap agreements are recorded as adjustments to interest expense.

At December 31, 2003, the combined fair market value of the two interest rate swaps we entered in 2001 was a liability of approximately \$2.4 million, included in accounts payable, accrued expenses and other liabilities on the consolidated balance sheets. Interest paid or payable under the terms of the swaps of approximately \$4.1 million and \$3.5 million, is included in interest expense for the years ended December 31, 2003 and 2002, respectively. The combined fair market value of the two new interest rate swaps we entered into in 2003 was an asset of approximately \$1.78 million, included in the other assets on the consolidated balance sheets.

At December 31, 2003, the interest rate cap was recorded as an asset with a fair market value of \$34,004 included in other assets on the consolidated balance sheets. Because we have not designated this derivative as a hedge, the change in fair market value flows through the consolidated statements of income, where it is included in interest income.

With respect to the portion of our floating rate financing programs which are not hedged, a change in TBMA rate would result in increased or decreased payments under these financing programs, without a corresponding change in cash flows from the investments in revenue bonds. For example, based on the unhedged \$803 million (\$953 million outstanding under these financing programs at December 31, 2003, less the \$150 million notional amount subsequently hedged and assuming a perfect hedge correlation), we estimate that an increase of 1.0% in TBMA rate would decrease our annual net income by approximately \$8.0 million. Conversely, a decrease in market interest rates would generally benefit us in the same amount described above, as a result of decreased allocations to the minority interest and interest expense without corresponding decreases in interest received on revenue bonds.

Changes in market interest rates would also impact the estimated fair value of our portfolio of revenue bonds. We estimate the fair value for each revenue bond as the present value of its expected cash flows, using a discount rate for comparable tax-exempt investments. Therefore, as market interest rates for tax-exempt investments increase, the estimated fair value of our revenue bonds will generally decline, and a decline in interest rates would be expected to result in an increase in their estimated fair values. For example, we estimate, using the same methodology used to estimate the portfolio fair market value under FAS 115, that a 1% increase in market rates for tax-exempt investments would decrease the estimated fair value of our portfolio of revenue bonds from its December 31, 2003 value of approximately

\$1,871,009,000 to approximately \$1,708,894,753. A 1% decline in interest rates would increase the value of the December 31, 2003 portfolio to approximately \$1,955,110,897. Changes in the estimated fair value of the revenue bonds do not impact our reported net income, earnings per share, distributions or cash flows, but are reported as components of other accumulated comprehensive income and affect reported shareholders' equity.

Changes in interest rates would also affect the PWF acquisition loan with Fleet, the PWF warehouse lines and the Related acquisition facility. A 1% change in the underlying interest rates would affect our annual net income by approximately \$931,000 (based on the outstanding balances at December 31, 2003 of approximately \$25.2 million for the PWF acquisition loan, \$21.9 million for the PWF warehouse line and \$24.5 million for the Related acquisition facility).

The assumptions related to the foregoing discussion of market risk involve judgments involving future economic market conditions, future corporate decisions and other interrelating factors, many of which are beyond our control and all of which are difficult or impossible to predict with accuracy. Although we believe that the assumptions underlying the forward-looking information are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking information included herein will prove to be accurate. Due to the significant uncertainties inherent in forward-looking information, the inclusion of such information should not be regarded as our representation that our objectives and plans would be achieved.

Liquidity Risk

Our investments generally lack a regular trading market, particularly during turbulent market conditions or if any of our tax-exempt revenue bonds become taxable or are in default. There is no limitation as to the percentage of investments that may be illiquid and we do not expect to invest a substantial portion of its assets in liquid investments. There is a risk involved in investing in illiquid investments, particularly in the event that we need additional cash. In a situation requiring additional cash, we could be forced to liquidate some of its investments on unfavorable terms that could substantially impact our consolidated balance sheet and reduce the amount of distributions available and payments made in respect of our shares.

Risk Associated with Securitization

Through securitizations, we seek to enhance our overall return on our investments and to generate proceeds that, along with equity offering proceeds, facilitate the acquisition of additional investments. In our debt securitizations, an investment bank and/or credit enhancer generally provides liquidity to the underlying trust and credit enhancement to the bonds, which enables the senior interests to be sold to certain accredited third party investors