



## REPORTS

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State of California

**MEMORANDUM****To:** Board of Directors**Date:** March 6, 2008

Bruce D. Gilbertson, Director of Financing

**From:** CALIFORNIA HOUSING FINANCE AGENCY**Subject:** REPORT OF BOND SALE AND INTEREST RATE SWAP AGREEMENTS  
HOME MORTGAGE REVENUE BONDS 2008 SERIES A, 2008 SERIES B AND 2008  
SERIES C

On January 29, 2008, the Agency delivered \$150,000,000 of bonds (the "Bonds") under the Home Mortgage Revenue Bond Indenture (HMRB) to Goldman Sachs & Co. The Bonds were issued as both tax exempt fixed rate bonds and tax exempt variable rate demand obligations, with liquidity provided by The Bank of New York (BNY). The Bonds were issued in three series, HMRB 2008 Series A, HMRB 2008 Series B and HMRB 2008 Series C. The 2008 Series A bonds are insured by FGIC and are rated Aaa/AAA by Moody's and Standard & Poor's respectively. The 2008 Series B and 2008 Series C bonds are not insured. Additional details of the Bonds are outlined in the attached summary.

The Bonds were issued to provide financing for eligible mortgage loans under the Agency's Home Mortgage Purchase Program. The Agency expects that \$51 million of the loans purchased with the proceeds will bear interest at a weighted average rate of 5.58% per annum and will be amortized over 30 years, \$7.3 million will bear interest at a weighted average rate of 5.54% and will be amortized over 40 years, \$84.5 million will bear interest at a weighted average pass-through rate of 6.03% per annum and will be used to purchase mortgage backed securities backed by 35-year IO loans and \$3 million will bear interest at a weighted average pass-through rate of 3.50% per annum and will be used to purchase mortgage backed securities backed by loans which will be amortized over 30 years. The Agency expects to be able to provide homes for over 600 families with the proceeds.

The Agency transferred portions of existing interest rate swap agreements with several counterparties totaling \$70,565,000 to the 2008 Series C Bonds. For all of the transferred swaps the Agency receives a variable rate of interest based on a percentage of one month LIBOR. The transfer of swaps enabled the Agency to reduce the amount of excess interest rate swap balances under the HMRB Indenture. After this transfer, approximately \$14 million of excess interest rate swap balances remain under the indenture. Additional details of the transferred Swaps are outlined in the attached summary.

**SUMMARY OF THE BONDS**

BOND SERIES	A	B	C
<b>Par Amount</b>	\$43,475,000.	\$35,960,000	\$70,565,000.
<b>Type of Bonds (Tax-exempt)</b>	FIXED (serial / term bonds)	Fixed (term bonds)	VRDO
<b>Tax Treatment</b>	AMT	AMT	AMT
<b>Maturities</b> \$43,475,000, on \$35,960,000, on \$70,565,000, on	2/1/2009-2/1/2020	2/1/2023 & 2/1/2028	8/1/2041
<b>Credit Rating</b> Moody's S&P	Aaa AAA	Aa2 AA-	Aa2/VMIG-1 AA-/A-1+
<b>Interest Rates</b> <b>Initial Interest Rate (VRDO)</b>	3.00%-4.50%	4.80% & 5.00%	1.90%
<b>Liquidity Provider</b>	N/A	N/A	Bank of New York
<b>Insurance Provider</b>	FGIC	N/A	NA
<b>Remarketing Agent</b>	N/A	N/A	Goldman Sachs & Co.

**SUMMARY OF THE SWAPS**

SERIES	A	B	C
<b>Notional Amounts</b> Swap #1 Swap #2 Swap #3 Swap #4 Swap #5 Swap #6	N/A	N/A	\$13,920,000 \$20,085,000 \$ 5,945,000 \$15,850,000 \$ 7,005,000 \$ 7,760,000
<b>Counterparties</b> Swap #1 Swap #2 Swap #3 Swap #4 Swap #5 Swap #6	N/A	N/A	Citi Merrill Lynch & Co. Lehman Brothers Merrill Lynch & Co. Bear Stearns & Co. Merrill Lynch & Co.
<b>Effective Dates</b> Swap #1 Swap #2 Swap #3 Swap #4 Swap #5 Swap #6	N/A	N/A	4/6/00 5/25/00 7/27/00 5/31/01 6/6/02 8/8/02

SERIES	A	B	C
<b>Fixed Payor Rates</b>			
Swap #1	N/A	N/A	4.80%
Swap #2			5.16%
Swap #3			4.95%
Swap #4			4.143%
Swap #5			3.994%
Swap #6			3.863%
<b>Floating Rate Basis</b>			
Swap #1	N/A	N/A	65% of Libor
Swap #2			65% of Libor
Swap #3			65% of Libor
Swap #4			65% of Libor
Swap #5			65% of Libor
Swap #6			65% of Libor
<b>Reset Frequency</b>			
Swap #1	N/A	N/A	monthly
Swap #2			monthly
Swap #3			weekly
Swap #4			monthly
Swap #5			monthly
Swap #6			monthly
<b>Maturities</b>			
Swap #1	N/A	N/A	2/1/2023
Swap #2			8/1/2022
Swap #3			8/1/2023
Swap #4			8/1/2024
Swap #5			2/1/2024
Swap #6			8/1/2032

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**MEMORANDUM****To:** Board of Directors**Date:** March 6, 2008**From:** Bruce D. Gilbertson, Director of Financing  
**CALIFORNIA HOUSING FINANCE AGENCY****Subject:** UPDATE ON VARIABLE RATE BONDS AND INTEREST RATE SWAPS

Over a number of years the Agency has integrated the use of variable rate debt as a primary issuance strategy in providing capital to support its programmatic goals. Most of our interest rate exposure from variable rate debt is hedged in the swap market. This strategy has enabled us to achieve a significantly lower cost of funds and a better match between assets and liabilities.

The following report describes our variable rate bond and interest rate swap positions as well as the related risks associated with this financing strategy. The report is divided into sections as follows:

- Variable Rate Debt Exposure
- Fixed-Payer Interest Rate Swaps
- Basis Risk and Basis Swaps
- Risk of Changes to Tax Law
- Amortization Risk
- Termination Risk
- Types of Variable Rate Debt
- Liquidity Providers
- Bond and Swap Terminology

**VARIABLE RATE DEBT EXPOSURE**

This report describes the variable rate bonds and notes of CalHFA and is organized programmatically by indenture as follows: HMRB (Home Mortgage Revenue Bonds--CalHFA's largest single family indenture), MHRB (Multifamily Housing Revenue Bonds III--CalHFA's largest multifamily indenture), HPB (Housing Program Bonds--CalHFA's multipurpose indenture, used to finance a variety of loans including the Agency's downpayment assistance loans), and DDB (Draw Down Bonds used to preserve tax-exempt authority.) The total amount of CalHFA variable rate debt is \$5.5 billion, 68% of our \$8 billion of total indebtedness as of February 1, 2008.

	VARIABLE RATE DEBT (\$ in millions)			
	Tied Directly to Variable Rate Assets	Swapped to Fixed Rate	Not Swapped or Tied to Variable Rate Assets	Total Variable Rate Debt
HMRB	\$2	\$3,729	\$579	\$4,310
MHRB	172	867	26	1,065
HPB	0	35	76	111
DDB	0	0	0	0
Total	\$174	\$4,631	\$681	\$5,486

As shown in the table above, our "net" variable rate exposure is \$681 million, 8.49% of our indebtedness. The net amount of variable rate bonds is the amount that is neither swapped to fixed rates nor directly backed by complementary variable rate loans or investments. The \$681 million of net variable rate exposure (\$507 million taxable and \$174 million tax-exempt) is offset by the Agency's balance sheet and excess swap positions. While our current net exposure is not tied directly to variable rate assets, we have approximately \$597 million (six month average balance as of 9/30/07) of other Agency funds invested in the State Treasurer's investment pool (SMIF) earning a variable rate of interest. From a risk management perspective, the \$597 million is a balance sheet hedge for the \$681 million of net variable rate exposure.

In order to maintain a certain level of confidence that the balance sheet hedge is effective, we have reviewed the historical interest rates earned on investments in the SMIF and LIBOR interest rate resets (most of our unhedged taxable bonds are index floaters that adjust at a spread to LIBOR). Using the data for the last ten years, we determined that there is a high degree of correlation between the two asset classes (SMIF and LIBOR) and that for every \$1 invested in SMIF we can potentially hedge \$1 of LIBOR-based debt.

The net variable rate exposure is further reduced by two other considerations: 1) as mentioned in the Amortization Risk section of this report, we have \$14 million notional amount of interest rate

swaps in excess of the original bonds they were to hedge, and 2) a portion of our unhedged exposure is tax-exempt debt which resets at the theoretical ratio of 65% of Libor. These two considerations serve to reduce the net effective variable rate exposure to the equivalent of \$611 million of LIBOR-based debt. As a result, the \$597 million of other Agency funds invested in SMIF effectively hedges approximately 98% of our current net variable rate exposure.

In addition, taking unhedged variable rate exposure mitigates the amortization risk without the added cost of purchasing swap optionality. Our unhedged variable rate bonds are callable on any date and allow for bond redemption or loan recycling without the cost of par termination rights or special bond redemption provisions. In addition, taking unhedged variable rate exposure diversifies our interest rate risks by providing benefits when short-term interest rates rise slower than the market consensus. In a liability portfolio that is predominately hedged using long-dated swaps, the unhedged exposure balances the interest rate profile of the Agency's outstanding debt.

#### **FIXED-PAYER INTEREST RATE SWAPS**

Currently, we have a total of 138 "fixed-payer" swaps with thirteen different counterparties for a combined notional amount of \$4.6 billion. All of these fixed-payer swaps are intended to establish synthetic fixed rate debt by converting our variable rate payment obligations to fixed rates. These interest rate swaps generate significant debt service savings in comparison to our alternative of issuing fixed-rate bonds. This savings allows us to continue to offer loan products with exceptionally low interest rates to multifamily sponsors and to first-time homebuyers. The table below provides a summary of our notional swap amounts.

#### FIXED PAYER INTEREST RATE SWAPS (notional amounts) (\$ in millions)

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
HMRB	\$3,110	\$625	\$3,735
MHRB	867	0	867
HPB	<u>35</u>	<u>0</u>	<u>35</u>
TOTALS	\$4,012	\$625	\$4,637

The following table shows the diversification of our fixed payer swaps among the thirteen firms acting as our swap counterparties. Note that our swaps with Lehman Brothers, Bear Stearns, and Goldman Sachs are with highly-rated structured subsidiaries that are special purpose vehicles used only for derivative products. We have chosen to use these subsidiaries because the senior credit of those firms is not as strong as that of the other firms. Note also that our most recent swaps with Merrill Lynch are either with their highly-rated structured subsidiary or we are benefiting from the credit of this triple-A structured subsidiary through a guarantee.

## SWAP COUNTERPARTIES

<u>Swap Counterparty</u>	<u>Credit Ratings</u>			<u>Notional Amounts Swapped (\$ in millions)</u>	<u>Number of Swaps</u>
	<u>Moody's</u>	<u>S &amp; P</u>	<u>Fitch</u>		
Merrill Lynch Capital Services Inc.					
Guaranteed by:					
Merrill Lynch & Co.	A1	A+	A+	\$ 624.8	18
MLDP, AG	Aaa	AAA	AAA	279.3	12
Merrill Lynch					
Derivative Products, AG	Aaa	AAA	AAA	360.3	17
Bear Stearns					
Financial Products Inc.	Aaa	AAA	NR	815.3	15
				289.7 *	8 *
Citigroup Financial					
Products Inc.	Aa3	AA-	AA	703.7	20
Lehman Brothers					
Derivative Products Inc.	Aaa	AAA <sup>t</sup>	NR	485.0	21
Goldman Sachs Mitsui Marine					
Derivative Products, L.P.	Aaa	AAA	NR	336.2	7
				313.5 *	5 *
AIG Financial Products Corp.	Aa2	AA	AA	314.1	9
JP Morgan Chase Bank	Aaa	AA	AA	211.0	7
Bank of America, N.A.	Aaa	AA+	AA+	206.8	5
Morgan Stanley					
Capital Services Inc	Aa3	AA-	AA-	136.7	2
BNP Paribas	Aa1	AA+	AA	88.0	2
UBS AG	Aaa	AA	AA	50.9	2
The Bank of New York	Aaa	AA-	AA	<u>25.0</u>	<u>1</u>
				\$4,637.1	138

\* Basis Swaps (not included in totals)

With interest rate swaps, the "notional amount" (equal to the principal amount of the swapped bonds) itself is not at risk. Instead, the risk is that a counterparty would default and, because of market changes, the terms of the original swap could not be replicated without additional cost.

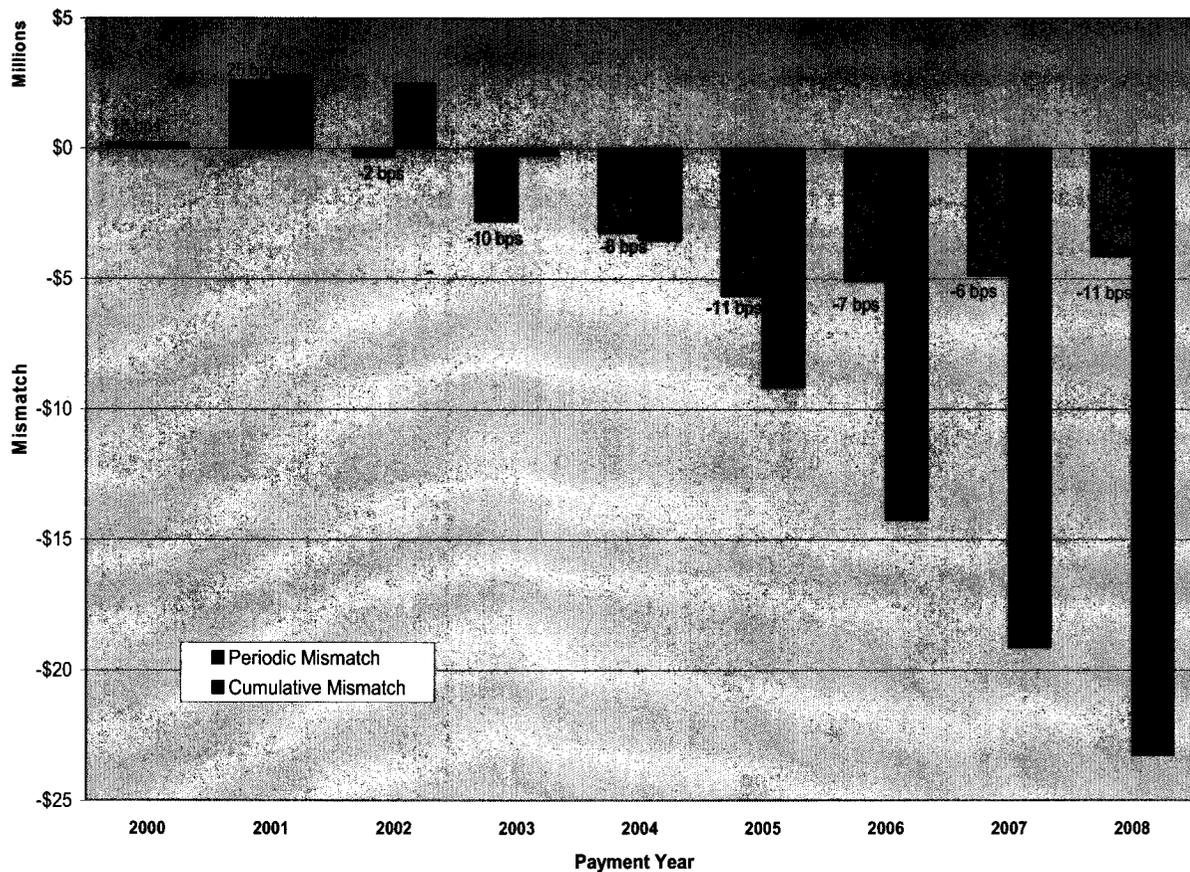
For all of our fixed-payer swaps, we receive floating rate payments from our counterparties in exchange for a fixed-rate obligation on our part. In today's market, the net periodic payment owed under these swap agreements is from us to our counterparties. As an example, on our February 1, 2008 semiannual debt service payment date we made a total of \$13.6 million of net payments to our counterparties. Conversely, if short-term rates were to rise above the fixed rates of our swap agreements, then the net payment would run in the opposite direction, and we would be on the receiving end.

**BASIS RISK AND BASIS SWAPS**

Almost all of our swaps contain an element of what is referred to as “basis risk” – the risk that the floating rate component of the swap will not match the floating rate of the underlying bonds.

This risk arises because our swap floating rates are based on indexes, which consist of market-wide averages, while our bond floating rates are specific to our individual bond issues. The only exception is where our taxable floating rate bonds are index-based, as is the case of the taxable floaters we have sold to the Federal Home Loan Banks. The chart below is a depiction of the basis mismatch that we have encountered since 2000 when we entered the swap market.

**Basis Mismatch through February 1, 2008  
All Tax-Exempt Swaps**



As the chart shows, the relationship between the two floating rates changes as market conditions change. Some periodic divergence was expected when we entered into the swaps. Over the lifetime of our swaps we have experienced more than \$20 million of additional interest expense due to this basis mismatch. However, we have since mitigated much of this risk by changing our swap formula in 2005, as explained below. The result of these changes has decreased the periodic mismatch from 11 basis points in 2005 to 6 basis points in 2007.

In the past we entered into swaps at a ratio of 65% of LIBOR, the London Inter-Bank Offered Rate which is the index used to benchmark taxable floating rate debt. These percentage-of-LIBOR swaps have afforded us with excellent liquidity and great savings when the average SIFMA/LIBOR ratio was steady at 65%. As short-term rates fell to historic lows and with an increased market supply of tax-exempt variable rate bonds, the historic relationship between tax-exempt and taxable rates was not maintained. For example, the average SIFMA/LIBOR ratio was 84.3% in 2003, 81.5% in 2004, and 72.5% in 2005. Now that short-term rates have risen significantly, the ratio has begun to fall. In 2006, it averaged 67.7%, 69% for 2007 and the average for 2008 to date is 70.1%. The SIFMA (Securities Industry and Financial Markets Association) index is the index used to benchmark tax-exempt variable rates.

When the SIFMA/LIBOR ratio is very high the swap payment we receive falls short of our bond payment, and the all-in rate we experience is somewhat higher. The converse is true when the percentage is low. In response, we and our advisors looked for a better formula than a flat 65% of LIBOR. After considerable study of California tax-exempt variable rate history, we revised the formula in December of 2002 to 60% of LIBOR plus 0.26% which resulted in comparable fixed-rate economics but performed better when short-term rates were low and the SIFMA/LIBOR percentage was high. In December 2005 we looked at the formula again and after completing a statistical analysis of CalHFA variable rate bonds as compared to the SIFMA and LIBOR indexes and taking into consideration the changing market conditions, we've decided to utilize several different swap formulas for our different types of bonds. After careful monitoring of the new swap formulas and adjusting for changing market conditions, we modified the swap formulas again in September 2007. The new swap formulas for AMT bonds are: 63% of LIBOR plus 0.30% for weekly resets and 63% of LIBOR plus 0.24% for daily resets. We expect to use these new formulas for new swap transactions and we will continue to monitor the SIFMA/LIBOR relationship and the performance of the new swap formulas and make adjustments as necessary.

In addition, we currently have basis swaps for \$603 million of the older 65% of LIBOR swaps. The basis swaps provide us with better economics in low-rate environments by exchanging the 65% of LIBOR formula for alternative formulas that alleviate the effects of high SIFMA/LIBOR ratios. The table on the next page shows the diversification of variable rate formulas used for determining the payments received from our interest rate swap counterparties.

**BASIS FOR VARIABLE RATE PAYMENTS  
RECEIVED FROM SWAP COUNTERPARTIES**  
(notional amounts)  
(\$ in millions)

	<u>Tax-Exempt</u>	<u>Taxable</u>	<u>Totals</u>
60% of LIBOR + 26bps	\$1,819	\$0	\$1,819
62% of LIBOR + 25bps	567	0	567
3 mo. LIBOR + spread	0	432	432
SIFMA – 15bps	431	0	431
Enhanced LIBOR <sup>1</sup>	313	0	313
Stepped % of LIBOR <sup>2</sup>	290	0	290
65% of LIBOR	273	0	273
1 mo. LIBOR	0	183	183
97% of SIFMA	77	0	77
SIFMA – 20bps	59	0	59
63% of LIBOR + 24bps	50	0	50
6 mo. LIBOR	0	44	44
60% of LIBOR + 21bps	35	0	35
64% of LIBOR	26	0	26
63% of LIBOR + 30bps	25	0	25
64% of LIBOR + 25bps	<u>13</u>	<u>0</u>	<u>13</u>
TOTALS	\$3,978	\$659	\$4,637

<sup>1</sup> Enhanced LIBOR – This formula is 50.6% of LIBOR plus 0.494% with the proviso that the end result can never be lower than 61.5% of LIBOR nor greater than 100% of LIBOR.

<sup>2</sup> Stepped % of LIBOR – This formula has seven incremental steps where at the low end of the spectrum the swap counterparty would pay us 85% of LIBOR if rates should fall below 1.25% and at the high end, they would pay 60% of LIBOR if rates are greater than 6.75%.

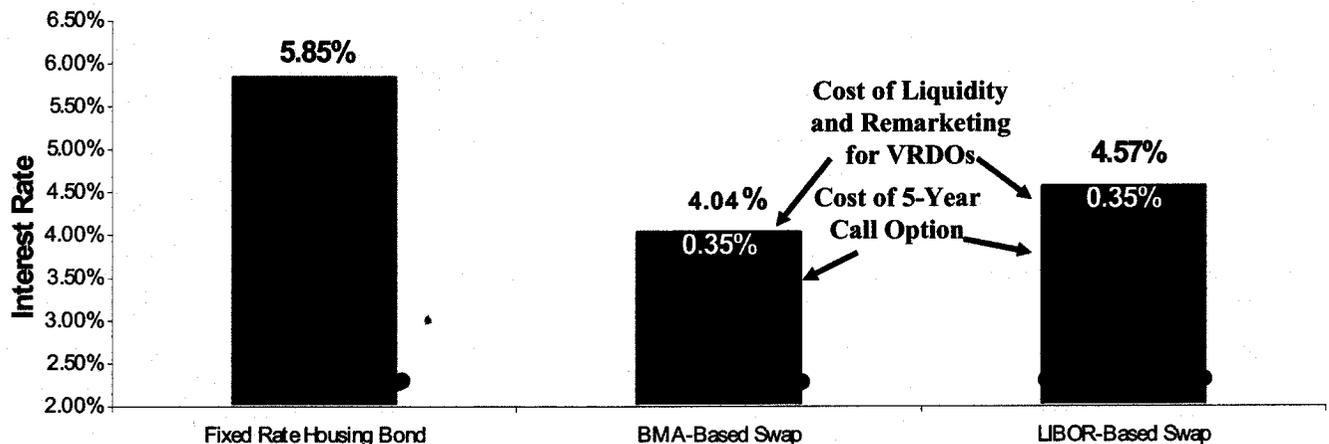
**RISK OF CHANGES TO TAX LAW**

For an estimated \$3.4 billion of the \$4 billion of tax-exempt bonds swapped to a fixed rate, we remain exposed to certain tax-related risks, another form of basis risk. In return for significantly higher savings, we have chosen through these interest rate swaps to retain exposure to the risk of changes in tax laws that would lessen the advantage of tax-exempt bonds in comparison to taxable securities. In these cases, if a tax law change were to result in tax-exempt rates being more comparable to taxable rates, the swap provider's payment to us would be less than the rate we would be paying on our bonds, again resulting in our all-in rate being higher.

We bear this same risk for \$232 million of our tax-exempt variable rate bonds which we have not swapped to a fixed rate. Together, these two categories of variable rate bonds total \$3.6 billion, 45.6% of our \$8 billion of bonds outstanding. This risk of tax law changes is the same risk that investors take when they purchase our fixed-rate tax-exempt bonds.

The following bar chart shows the current benefit of our ability to assume the risk of changes to tax laws. Over the last several years this benefit (the difference between the cost of fixed rate housing bonds and the cost of a LIBOR based interest rate swap financing) has been as great as 100 basis points, and was the engine that made our interest rate swap strategy effective. In today's market with tax-exempt fixed rate bonds trading at yields in excess of taxable bonds this benefit is as much as 128 basis points. These market conditions provide extraordinary challenges for new bond issuances, however we don't expect these relationships to continue. The reduced economic benefit of assuming tax risk has led to recent decisions to issue some or all of our bonds as fixed rate housing bonds, especially for our homeownership programs. As market conditions change we will alter our financing strategies to obtain the lowest cost of borrowing while balancing the associated risks and benefits of alternative structures.

**Costs of Funds for Fixed-Rate Bonds and Synthetic Fixed-Rate Bonds  
(Variable Rate Bonds Swapped to Fixed)  
(All Rates as of March 3, 2008)**



SIFMA-Based Swap: SIFMA Index x 101%

LIBOR-Based Swap: 63% LIBOR + 24 bps

**AMORTIZATION RISK**

Our bonds are generally paid down (redeemed or paid at maturity) as our loans are prepaid. Our interest rate swaps amortize over their lives based on assumptions about the receipt of prepayments, and the single family transactions which include swapped bonds have generally been designed to accommodate prepayment rates between two and three times the "normal" rate. In other words, our interest rate swaps generally have had fixed amortization schedules that can be met under what we have believed were sufficiently wide ranges of prepayment speeds. Unfortunately, when market rates fell to unprecedented levels, we started receiving more prepayments than we ever expected.

Since January 1, 2002, we have received over \$6.6 billion of prepayments, including over \$1.4 billion in 2004, \$1.1 billion in 2005, \$504 million in 2006 and \$278 million in 2007. Of this amount, approximately \$2.03 billion is "excess" to swapped transactions we entered into. We have since recycled \$1.94 billion of the \$2.03 billion excess into new loans and have used \$166 million to cross-call high interest rate bonds.

While these persistent high levels of prepayments have eased, we have modified the structuring of new swaps by widening the band of expected prepayments. In addition, with the introduction of our interest only loan product we are structuring swap amortization schedules and acquiring swap par termination rights to coincide with the loan characteristics and expectations of borrower prepayment.

Also of interest is a \$14 million forced overswap mismatch between the notional amount of certain of our swaps and the outstanding amount of the related bonds. This mismatch has occurred as a result of the interplay between our phenomenally high incidence of prepayments and the "10-year rule" of federal tax law. Under this rule, prepayments received 10 or more years beyond the date of the original issuance of bonds cannot be recycled into new loans and must be used to redeem tax-exempt bonds. In the case of these recent bond issues, a portion of the authority to issue them on a tax-exempt basis was related to older bonds.

While this mismatch has occurred (and will show up in the tables of this report), the small semiannual cost of the mismatch will be more than offset by the large interest cost savings from our "net" variable rate debt. In other words, while some of our bonds are "over-swapped", there are significantly more than enough unswapped variable rate bonds to compensate for the mismatch. In addition, we will monitor the termination value of our "excess swap" position looking for opportunities to unwind these positions when market terminations would be at no cost or a positive value to us.

There are several strategies for dealing with excess prepayments: they may be reinvested, used for the redemption of other (unswapped) bonds, or recycled directly into new loans. Alternatively, we could make termination payments to our counterparties to reduce the notional amounts of the swaps, but this alternative appears to be the least attractive economically.

In consultation with our financial advisors, we have determined that the best long-term strategy is to recycle the excess prepayments into new CalHFA loans. Of course, for some financings this means that we will be bearing the economic consequences of replacing old 7% to 8% loans that have paid off with new loans at rates that will be current at the time we recycle. With our May 1, 2007 transfer of loans from our warehouse line we have recycled a total of \$1.94 billion of excess prepayments since March 1999. This practice has resulted in reduced issuance activity over the last few years.

In addition we have begun a widespread strategy of reusing unrestricted loan prepayments to purchase new loans. We currently have more than \$3.2 billion (87%) of swap notional having a fixed payer rate below the estimated net weighted average interest rate of 5.75% for new loans being reserved. In today's market, this tremendous recycling opportunity reduces transaction costs related to new issuance and preserves for future use our swap par termination rights.

### TERMINATION RISK

Termination risk is the risk that, for some reason, our interest rate swaps must be terminated prior to their scheduled maturity. Our swaps have a market value that is determined based on current interest rates. When current fixed rates are higher than the fixed rate of the swap, our swaps have a positive value to us (assuming, as is the case on all of our swaps today, that we are the payer of the fixed swap rate), and termination would result in a payment from the provider of the swap (our swap "counterparty") to us. Conversely, when current fixed rates are lower than the fixed rate of the swap, our swaps have a negative value to us, and termination would result in a payment from us to our counterparty.

Our swap documents allow for a number of termination "events", i.e., circumstances under which our swaps may be terminated early, or (to use the industry phrase) "unwound". One circumstance that would cause termination would be a payment default on the part of either counterparty. Another circumstance would be a sharp drop in either counterparty's credit ratings and, with it, an inability (or failure) of the troubled counterparty to post sufficient collateral to offset its credit problem. It should be noted that, if termination is required under the swap documents, the market determines the amount of the termination payment and who owes it to whom. Depending on the market, it may be that the party who has caused the termination is owed the termination payment.

As part of our strategy for protecting the agency when we entered the swap market in late 1999, we determined to choose only highly-creditworthy counterparties and to negotiate "asymmetrical" credit requirements in all of our swaps. These asymmetrical provisions impose higher credit standards on our counterparties than on the agency. For example, our counterparties may be required to collateralize their exposure to us when their credit ratings fall from double-A to the highest single-A category (A1/A+), whereas we need not collateralize until our ratings fall to the mid-single-A category (A2/A).

Monthly we monitor the termination value of our swap portfolio as it grows and as interest rates change. Because termination is an unlikely event, the fact that our swap portfolio has a negative value, while interesting, is not necessarily a matter of direct concern. We have no plans to terminate swaps early (except in cases where the swap notional is excess to the bonds being hedged or we negotiated "par" terminations when we entered into the swaps) and do not expect that credit events triggering termination will occur, either to us or to our counterparties.

Currently, the Government Accounting Standards Board only requires that our balance sheet and income statement be adjusted for the market value of our swaps in excess of the bonds being hedged. However, it does require that the market value be disclosed for all of our swaps in the notes to our financial statements.

The table below shows the history of the fluctuating negative value of our swap portfolio for the past year.

TERMINATION VALUE HISTORY

<u>Date</u>	<u>Termination Value (\$ in millions)</u>
3/31/07	(\$137.7)
4/30/07	(\$129.3)
5/31/07	(\$83.2)
6/30/07*	(\$41.0)
7/31/07	(\$64.4)
8/31/07	(\$101.8)
9/30/07	(\$110.1)
10/31/07	(\$120.5)
11/30/07	not available
12/31/07	(\$224.7)
1/31/08	not available
2/29/08	(\$281.3)

\* *As reported on the Financial Statements.*

It should be noted that during this period, the notional amount of our fixed-payer swaps has been increasing. When viewing the termination value, one should consider both the change in market conditions and the increasing notional amount.

**TYPES OF VARIABLE RATE DEBT**

The table below shows our variable rate debt sorted by type, i.e., whether auction rate, indexed rate, or variable rate demand obligations (VRDOs). Auction and indexed rate securities cannot be "put" back to us by investors; hence they typically bear higher rates of interest than do "puttable" bonds such as VRDOs.

**TYPES OF VARIABLE RATE DEBT**  
*(\$ in millions)*

	Auction Rate & Similar <u>Securities</u>	Indexed Rate <u>Bonds</u>	Variable Rate Demand <u>Obligations</u>	Total Variable Rate <u>Debt</u>
HMRB	\$154	\$979	\$3,178	\$4,311
MHRB	394	0	671	1,065
HPB	0	0	111	111
DDB	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total	\$548	\$979	\$3,960	\$5,487

**LIQUIDITY PROVIDERS**

The table below shows the financial institutions providing liquidity in the form of standby bond purchase agreements for our VRDOs. Under these agreements, if our variable rate bonds are put back to our remarketing agents and cannot be remarketed, these institutions are obligated to buy the bonds.

LIQUIDITY PROVIDERS  
(*\$ in millions*)

<u>Financial Institution</u>	<u>\$ Amount of Bonds</u>	<u>Indenture</u>
Dexia Credit Local	\$801.2	HMRB
Lloyds TSB	431.3	HMRB
Fannie Mae	370.0	HMRB/MHRB
BNP Paribas	259.5	HMRB
KBC	252.2	HMRB
Bank of Nova Scotia	209.1	HMRB
DEPFA Bank	182.9	MHRB
Calyon	174.5	HMRB
Bank of New York	156.6	HMRB
JP Morgan Chase Bank	154.9	HMRB
Bayerische Landesbank	152.7	HMRB
Landesbank Hessen-Thuringen	149.8	MHRB
Westdeutsche Landesbank	148.3	HMRB/MHRB
Bank of America	129.7	HMRB
Fortis	120.0	HMRB
State Street Bank	90.5	HMRB
CalSTRS	65.9	HMRB/MHRB
LBBW	61.1	HPB
Citibank N.A.	50.0	HPB
Total	\$3,960.2	

Unlike our interest rate swap agreements, our liquidity agreements do not run for the life of the related bonds. Instead, they are seldom offered for terms in excess of five years, and a portion of our agreements require annual renewal. We expect all renewals to take place as a matter of course; however, changes in credit ratings or pricing may result in substitutions of one bank for another from time to time.

**BOND AND SWAP TERMINOLOGY****COUNTERPARTY**

One of the participants in an interest rate swap

**DATED DATE**

Date from which first interest payment is calculated.

**DELAYED START SWAP**

A swap which delays the commencement of the exchange of interest rate payments until a later date.

**DELIVERY DATE, OR ISSUANCE DATE**

Date that bonds are actually delivered to the underwriters in exchange for the bond proceeds.

**GENERAL OBLIGATION BOND**

A type of security which is evidence of a debt secured by all revenues and assets of an organization.

**INDENTURE**

The legal instrument that describes the bonds and the pledge of assets and revenues to investors. The indenture often consists of a general indenture plus separate series indentures describing each issuance of bonds.

**INTEREST RATE CAP**

A financial instrument which pays the holder when market rates exceed the cap rate. The holder is paid the difference in rate between the cap rate and the market rate. Used to limit the interest rate exposure on variable rate debt.

**INTEREST RATE SWAP**

An exchange between two parties of interest rate exposures from floating to fixed rate or vice versa. A fixed-payer swap converts floating rate exposure to a fixed rate.

**LIBOR**

London Interbank Offered Rate. The interest rate highly rated international banks charge each other for borrowing U.S. dollars outside of the U.S. Taxable swaps often use LIBOR as a rate reference index. LIBOR swaps associated with tax-exempt bonds will use a percentage of LIBOR as a proxy for tax-exempt rates.

**MARK-TO-MARKET**

Valuation of securities or swaps to reflect the market values as of a certain date. Represents liquidation or termination value.

**MATURITY**

Date on which the principal amount of a bond is scheduled to be repaid.

**NOTIONAL AMOUNT**

The principal amount on which the exchanged swap interest payments are based.

**OFFICIAL STATEMENT**

The "prospectus" or disclosure document describing the bonds being offered to investors and the assets securing the bonds.

**PRICING DATE**

Date on which issuer agrees (orally) to sell the bonds to the underwriters at certain rates and terms.

**REDEMPTION**

Early repayment of the principal amount of the bond. Types of redemption: "special", "optional", and "sinking fund installment".

**REFUNDING**

Use of the proceeds of one bond issue to pay for the redemption or maturity of principal of another bond issue.

**REVENUE BOND (OR SPECIAL OBLIGATION BOND) (OR LIMITED OBLIGATION BOND)**

A type of security which is evidence of a debt secured by revenues from certain assets (loans) pledged to the payment of the debt.

**SIFMA INDEX**

Securities Industry and Financial Markets Association Municipal Swap Index. A weekly index of short-term tax-exempt rates.

**SALE DATE**

Date on which purchase contract is executed evidencing the oral agreement made on the pricing date.

**SERIAL BOND**

A bond with its entire principal amount due on a certain date, without scheduled sinking fund installment redemptions. Usually serial bonds are sold for any principal amounts to be repaid in early (10 or 15) years.

**SERIES OF BONDS**

An issuance of bonds under a general indenture with similar characteristics, such as delivery date or tax treatment. Example: "Name of Bonds", 1993 Series A. Each series of Bonds has its own series indenture.

**SWAP CALL OPTION**

The right (but not the obligation) to terminate a predetermined amount of swap notional amount, occurring or starting at a specific future date.

**SYNTHETIC FIXED RATE DEBT**

Converting variable rate debt into a fixed rate obligation through the use of fixed-payer interest rate swaps.

**SYNTHETIC FLOATING RATE DEBT**

Converting fixed rate debt into a floating rate obligation through the use of fixed-receiver interest rate swaps.

**TERM BOND**

A bond with a stated maturity, but which may be subject to redemption from sinking fund installments. Usually of longer maturity than serial bonds.

**VARIABLE RATE BOND**

A bond with periodic resets in its interest rate. Opposite of fixed rate bond.

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126 THE WELCHWAY | JACK &amp; SUZY WELCH

## Directors Who Don't Deliver

These five types of dysfunctional board members "serve" at many companies

I sit on a board with two members who, for the past year, have said and done little. Both were just reelected unanimously with the support of the nominating committee. What's your take?

Anonymous  
NEW YORK

So, two seat-warmers on your board were just reelected unanimously, you say? Doesn't that mean you voted for them too? If so, don't worry. You're not the only director in history to endure an ineffective or otherwise dysfunctional peer. Not to slam boards; on the whole, they add real value. But boards frequently tolerate troublesome performance from one or two of their own. It's simply too time-consuming or impolitic to eradicate. And that is why too many boards, in both the public and private sectors, don't make the contribution they should.

To be clear, we're not talking about board behavior that is criminal. With a few famous exceptions, boards will remove anyone who breaks the law. No, we're referring to boardroom behaviors that are perfectly legal but perfectly destructive as well. There are at least five by our count:

**THE DO-NOTHING.** Let's start with the type of bad board member you describe. Some of these individuals are too busy with their own companies, other directorships, or their personal lives to care

about your board. Some don't have enough skin in the game to work up a real interest. Others lie low for job security. At \$25,000 to \$100,000 a pop, corporate directors get paid good money. In the private sector, prestige is often the reward. So Do-Nothings rarely challenge or probe. Nor do they venture into the field to make sure what they hear in the boardroom about values and strategy matches what employees feel.

**THE WHITE FLAG.** Do-Nothings are awful but not nearly as dangerous as type two in our taxonomy. These individuals live in fear of being personally tainted by any kind of controversy, such as a class action or activist protest. They lack a key characteristic of any good board member—courage. With every public or private challenge, they pollute the boardroom by hyperventilating for a settlement, even if it means selling out on principle just to get out of the crosshairs. Sure, a board must settle on occasion, but never before seeing the organization through a discovery of the facts. Such a process creates a culture of trust between management and the board, and it is only in such an environment that risks can and will be taken.

**THE CABALIST.** The third type of bad board member is the director who sits quietly in meetings, often going along with the prevailing side,

before taking up his cause behind the scenes and building constituencies to achieve another agenda, his own. In many cases, good board members shut down such practitioners of palace intrigue. But sometimes a board's cabal is its own executive committee, and the result is a controlling, secretive board-within-a-board that turns other directors into second-class citizens. Such a dynamic decommissions the majority of the

**THE PONTIFICATOR.** And finally, there is the self-important bloviator who cannot get enough of his own voice, especially when it is opining on "matters of state," such as world events, social trends, the company's history, or his own area of expertise. Like Meddlers, Pontificators distract boards from the business before them and enervate their colleagues in the process.

As a board member, it is easier to let a couple of Do-

Counterproductive directors, of any stripe, are a destructive force. But clearing them out can seem like too much trouble. It's not

board's brains—and what a waste that is—but it also undermines the board's relationship with management. Executives can't tell if a director is speaking for himself, the board, or the cabal.

**THE MEDDLER.** Good directors focus on big-picture issues such as succession and strategy. By contrast, our fourth "offender" likes to butt into management. Instead of meeting with high-potential talent and discussing industry dynamics, meddlers get all mucked up in operational details. They seem oblivious to the fact that board members are there for their wisdom, sound counsel, and judgment, not the day-to-day running of the business.

Nothings hang on till retirement or tolerate a few cowering White Flags as other directors handle each crisis. Or to try to isolate or work around Cabalists and ignore Meddlers and Pontificators. But imagine how much better it would be if nominating committees, usually just focused on vetting potential members, dealt with the hard cases right in front of them. After all, nothing can keep a board on its best behavior but itself. | BW |

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Jack and Suzy Welch await your questions. E-mail them at [thewelchway@businessweek.com](mailto:thewelchway@businessweek.com). For their VIDEO PODCAST, go to [businessweek.com/search/podcasting.htm](http://businessweek.com/search/podcasting.htm).

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State of California

## MEMORANDUM

To: CalHFA Board of Directors

Date: 6 March 2008

From: Di Richardson, Director of Legislation *DR*  
CALIFORNIA HOUSING FINANCE AGENCY

Subject: Legislative Report

We have passed the deadline for introducing most bills. My staff and I are still working through all the specifics, but below you will find a list of those we thought you might be interested in.

### Bonds

**AB 2867** (De Leon) Housing and Emergency Shelter Trust Fund of 2006: green construction. (I-02/22/2008)  
Status: Introduced – pending referral to a committee.

**Summary:**

This bill would require the Department of Housing and Community Development to adopt regulations establishing a mechanism to grant priority points for approved applications (Prop 1C funds) for housing projects that are energy efficient and utilize green construction methods in their development.

**SB 546** (Ducheny) Department of Housing and Community Development: bond fund expenditures: report. (A-06/25/2007)  
Status: 09/04/2007-Placed on inactive file on request of Assembly Member Bass.  
Current Location: Assembly Inactive File  
Calendar Events:

**Summary:**

This bill would require HCD to include specific information in their annual report regarding allocations from Propositions 46 and 1C.

## Insurance

**AB 2509** (Galgiani) Housing finance: mortgage guarantee program. (I-02/21/2008)

**Status:** pending referral to committee.

**Summary:**

This bill would require CalHFA to establish and administer the Homeownership Preservation Mortgage Guarantee Program to allow redevelopment agencies, nonprofit community lenders, and small business financial development corporations selected by the agency (administrators) to accept and approve applications for a 5 year, 20% loan guarantee for income-qualified owner-occupant borrowers who currently have an adjustable rate mortgage loan that is scheduled to have a payment increase that they cannot afford. The program would be funded by a \$50 million appropriation.

## Mortgage Lending

**AB 529** (Torrico) Mortgages: adjustable interest rates: notification. (A-01/22/2008)

**Status:** Pending before Senate Committee on Banking, Finance and Insurance.

**Summary:**

This bill would require a lender, who provides an adjustable rate loan secured by property improved by 4 or fewer residential units, to notify the borrower of specified information regarding the impact of the rate change 20 days, 60 days, and 30 days prior to an interest rate adjustment. The bill would provide that the notification requirements are satisfied if the lender either personally delivers the notice or mails it.

**AB 1830** (Lieu) High-cost, subprime, and nontraditional loans. (I-01/23/2008)

**Status:** Pending before Assembly Committee on Banking and Finance.

**Summary:**

This bill would redefine a "covered loan" as a "high-cost loan," would establish "subprime loans" and "nontraditional loans," as defined, as new categories of regulated loans, making various conforming changes to existing law relative to these loans. The bill would prohibit a high-cost loan from including prepayment penalties and from including at origination a payment schedule with regular periodic payments that, when aggregated, do not fully amortize the principal balance as of the maturity date of the loan. The bill would prohibit a person from making a high-cost loan unless at the time the loan is consummated the person believes the consumer will be able to make the scheduled payments, including taxes and insurance and would prohibit a high-cost loan from being originated as a stated income loan, except as specified. The bill would prohibit a person who originates a high-cost loan from receiving a yield spread premium or other incentive compensation and would prohibit a person from originating a high-cost loan

unless an escrow or impound account is established for a specified period of time. The bill would delete the provisions requiring a disclosure to be provided to a consumer prior to making a covered loan and would instead prohibit a high-cost loan from being made unless a consumer receives a certificate of certain counseling. The bill would establish similar limitations and prohibitions for subprime and nontraditional loans but would require a specified disclosure to be provided to a consumer before those loans could be made. The bill would authorize a licensing agency to levy administrative penalties in an amount up to \$10,000 against a person who violates the provisions regulating high-cost, subprime, and nontraditional loans and would make a person who makes a willful and knowing violation of those provisions of law liable to the consumer in the amount of \$25,000 or the consumers actual damages, whichever is greater. The bill would authorize private causes of action by a consumer against a licensed person to recover damages for a violation of the provisions regulating high-cost, subprime, or nontraditional loans. The bill would provide that it is a defense against foreclosure on a property secured by a high-cost, subprime, or nontraditional loan if the loan is in violation of the laws regulating those loans. The bill's provisions would apply to high-cost, subprime, and nontraditional loans originated on or after January 1, 2009.

**AB 1837**

**(Garcia) Consumer loans: subprime and nontraditional loans.** (I-01/24/2008)

**Status:** Pending in Assembly Committee on Banking and Finance.

**Summary:**

This bill would prohibit a covered loan from including a prepayment penalty after the first 24 months from the date of consumation of the loan and would authorize a covered loan to include a prepayment penalty before that time period if specified conditions are satisfied. The bill would define the terms "subprime loan" and "nontraditional loan" and would prohibit these loans from including prepayment fees or penalties. The bill would also prohibit a licensed person from receiving any compensation for originating a subprime loan or nontraditional loan with an interest rate above the wholesale par rate for which the consumer qualifies. The bill's provisions would apply to consumer loans originated on or after January 1, 2009.

**AB 2123**

**(Lieu) California Financial Literacy Initiative.** (I-02/20/2008)

**Status:** Pending before Assembly Committee on Banking and Finance.

**Summary:**

This bill would establish the California Financial Literacy Initiative for the purpose of improving financial literacy by offering instructional materials to citizens of California. The initiative would be administered by the Controller, who would be authorized to provide, among other things, an online library of financial literacy resources and materials to be made available for all Californians. The Controller would be authorized to convene a Financial Literacy Advisory Committee that may include representatives of the office of the Superintendent of Public Instruction, the office of the Treasurer, the

Department of Corporations, the Department of Financial Institutions, and others invited by the Controller. The bill would require the Controller, as resources are available, to establish and oversee the California Financial Services Corps, which would provide certain financial information to low- and middle-income Californians who do not have financial advisors. The bill would require the Franchise Tax Board to coordinate the promotion and activities of the Financial Services Corps with the board's tax assistance programs. The bill would establish the California Financial Literacy Fund in the State Treasury and would authorize the Controller to deposit donations from nonprofit entities into the fund. The bill would authorize moneys in the fund, upon appropriation by the Legislature, to be used for the purpose of establishing the services specified in the initiative.

**SB 1055**

**(Machado) Taxation: cancellation of indebtedness: mortgage debt forgiveness.** (A-02/25/2008)

**Status:** Pending in Senate Committee on Appropriations.

**Summary:**

This bill would provide further conformity to federal income tax laws by conforming to specified provisions of the federal Mortgage Forgiveness Debt Relief Act of 2007, relating to the exclusion of the discharge of qualified principal residence indebtedness, as defined, from a taxpayer's income if that debt is discharged after January 1, 2007, and before January 1, 2009.

### **Special Needs Housing**

**SB 1175**

**(Steinberg) Developmental services: regional center housing.** (I-02/08/2008)

**Status:** Pending before Senate Committee on Human Services.

**Summary:**

This bill would allow the California Health Facilities Financing Authority to issue bonds for residential facilities for persons with developmental disabilities (similar to what CalHFA has done for the Bay Area Housing Plan). CalHFA and HCD would be required to consult with the department and review any financing plan before it could be approved.

### **Surplus Property**

**AB 1941**

**(Carter) Surplus land: disposal.** (I-02/13/2008)

**Status:** Currently pending before Assembly Committee on Local Government.

**Summary:**

This bill would require the state or local agency to offer to sell or lease the surplus land for any purpose to all governmental entities in whose jurisdiction the land is located. The bill would also allow a local agency, housing authority, or a redevelopment agency to reconvey property that it

has purchased to a for-profit developer for a development that is consistent with the redevelopment plan and general plan of the jurisdiction where the property is located.

### **Veterans**

#### **AB 2670**

**(Salas) Department of Veterans Affairs: qualified residential rental project programs. (1-02/22/2008)**

**Status:** Pending committee assignment

**Summary:**

This bill would require the Department of Veterans Affairs to apply to the California Debt Limit Allocation Committee for the issuance of a private activity bond under the qualified residential rental project program, as provided.

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