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MEMORANDUM

To: Board of Directors  Date: July 27, 2000

Ken Carlson, Director of Financing

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: REPORT OF BOND SALE AND PURCHASE OF FANNIE MAE'S CALIFORNIA FHA 236 PORTFOLIO

I am pleased to report that on July 26 we successfully delivered $274,747,417 of multifamily bonds to Fannie Mae in exchange for their portfolio of 278 FHA-insured Section 236 loans. As approved by the Board at its July 13 meeting, the financing was accomplished by means of a "pass-through" structure. CHFA is now the mortgagee of record, but the loan servicing will continue to be done by GMAC Commercial Mortgage Corporation. Loan revenues will flow from the servicer through a bond trustee on a monthly basis. These loan revenues (less servicing and administrative fees) will flow back to Fannie Mae as the bond investor.

Acquiring the Fannie Mae portfolio moves CHFA further toward achieving two goals -- retaining Section 236 Interest Reduction Payments ("IRP") to provide continued debt service subsidies and expanding CHFA's opportunities to preserve affordability after the expiration of the IRPs. CHFA staff is formulating a Section 236 preservation financing plan that will include direct communication to the project owners. CHFA staff will also be analyzing the portfolio data to determine what preservation strategies might be the most effective.

As we discussed at the previous Board meeting, staff is drafting an appropriate letter of appreciation to Fannie Mae for making this transaction possible.

Belated Matters

With the successful closing this week not only of this transaction but also of $278,285,000 of single family bonds (for which a report was provided at the July meeting), the total amount of CHFA bonds issued during the first seven months of this calendar year has reached $1,497,036,187. This amount already exceeds the amount of CHFA bonds issued during any previous entire calendar year.
MEMORANDUM

July 27, 2000

Ken Carlson, Director of Financing

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: VARIABLE RATE BONDS

The purpose of this memorandum is to provide a written version of my oral presentation made at the Board meeting of July 13, including copies of the accompanying visual aids. As I mentioned at the meeting, the presentation was a summary of the more detailed presentation Terri and I (along with our bankers and advisors) made to both Moody's Investors Service and Standard & Poor's Corporation on June 22 in New York City. I have also attached some recently-received material from Moody's, including a copy of their letter indicating an upgrade of the "outlook" for our issuer rating from "stable" to "positive".

Current Variable Rate Debt

Table 1 shows that, as of August 1, 2000, the Agency will have $1.472 billion of variable rate bonds outstanding. Of this amount, $74 million is directly backed by variable rate loans and another $894 million has been converted to "synthetic" fixed rates through the use of interest rate swaps. If we consider these two amounts of variable rate bonds as effectively hedged, then we are left with $504 million of "net" variable rate exposure not swapped to a fixed rate or backed by variable rate loans. This $504 million is 7.35% of our $6.85 billion of bonds outstanding as of August 1.

Paydown of Variable Rate Economic Refunding Bonds

Table 2 shows our three-year history of issuing $435 million of variable rate bonds for single family economic refundings. These refundings have involved the substitution of very-low-interest-rate variable rate bonds for high-interest-rate fixed rate bonds issued from 1987 to 1989 and the transfer of the remaining high-interest-rate, seasoned loan portfolios. The resulting wide spread between the old loan rates and the new bond rates had been providing us with significant economic benefit that we have used to "subsidize" our new transactions. As a result, we have been able to keep our loan rates low even though more than half our bonds for new loans carry taxable rates.

Table 2 shows how the outstanding principal amount of these nine series of variable rate economic refunding bonds is beginning to be paid down, to $370 million as of August 1, as borrowers prepay their high-interest-rate loans. Table 3 shows the actual semiannual paydown of the oldest of these variable rate refundings, from $53 million to $30 million in only three years. The early paydown of these refunding bonds was anticipated and was one of the reasons that we targeted this kind of opportunity as an appropriate place to accept interest rate risk.
2005
Relationship of HFA Economics to Interest Rates

Table 4 describes four reasons why housing finance agencies like CHFA suffer somewhat economically when interest rates fall and benefit economically when rates rise. These four areas are as follows:

Annuity Value: The most important source of net income for an HFA is the "spread" earned between the interest rate on loans and the interest rate on the bonds issued to fund the loans. In the case of single family loans, borrowers retain the option to prepay, and once they prepay, this income source terminates. When rates fall, borrowers are more likely to prepay old loans. In addition, when rates are low, it is more difficult for an HFA to achieve even a modest spread on new lower-rate loans, as the rate differential between a new HFA loan and a new market-rate loan declines. Hence, it may be that old higher-rate loans with higher spreads are king lost and being replaced by new loans with smaller spreads.

Real Estate Value: There are high correlations between falling rates and falling real estate values. For example, our restructuring of twenty or so multifamily loans and takeover of six projects appeared to have been primarily the result of the real estate recession of the early '90s. Interest rates reached a low in 1993, the same time that many of our loans were going into default.

Investment Returns: As described in our annual investment reports to the Board, we keep fairly large deposits in the State's Surplus Money Investment Fund, which works like a money market account. The returns on these deposits are directly affected by interest rates.

Asset Growth: When interest rates are low, it is more difficult for us to attract borrowers, whether single family or multifamily. Mortgage lenders find it easier to qualify first-time homebuyers for non-CHFA loans, and our loan volume may fall even if the usual rate differential between CHFA and non-CHFA loans can be maintained. In multifamily, low rates reduce the rate differential between CHFA's program and the programs provided by private credit enhancers working with local issuers. It seems as if this past year's comparative run-up in rates has been an important factor in CHFA's increased multifamily business.

Cashflow Modeline of CHFA Single Family Loan Program

Tables 5 and 6 show the results of our investment bankers' modeling of the CHFA Home Mortgage Revenue Bond program (with its $4 billion of single family loans) to show how its "residual value" would be affected by changes in interest rates. In Table 5 the residual value is seen to be fairly level even if short-term rates rise to 5.5% for tax-exempt variable rate bonds and 10% for taxable bonds. A level residual value means that, in the high rate scenarios, the increased annuity value of the assumed extended life of the loan portfolio is effectively offsetting the increase in interest costs from the higher rates on short-term debt. Table 6 shows the presumed effect of higher rates as well as a "massive tax event," where the marginal tax rate falls from the current 39.6% to zero, and tax-exempt bonds trade at the same rate as taxable bonds. Even in this unlikely case, the program still retains over 40% of its best case residual value when both tax-exempt and taxable rates average 10% over the program's life.
Tables 5 and 6 also show that, when the value of CHFA's deposits in the State's investment pool are added to the residual value of the loan program, the sum of these two amounts continues to rise as rates rise, even if all our bonds trade at taxable rates. This indicates that CHFA could comfortably issue some amount of additional variable rate bonds and consider them as being internally hedged by these short-term investment assets.

**Moody's Investors Service**

Attached are the following materials from Moody's:

1. Copy of letter dated July 7 regarding the outlook upgrade

2. Copy of draft report, "State Housing Agencies Issue Increasing Amounts of Variable Rate Debt" (included as useful background)

Attachments
<table>
<thead>
<tr>
<th></th>
<th>Tied Directly to Variable Rate Loans</th>
<th>Swapped to Fixed Rate</th>
<th>Not Swapped or Tied to Variable Rate Loans</th>
<th>Total Variable Rate Debt</th>
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<tr>
<td>Single Family</td>
<td>$ 57</td>
<td>$ 794</td>
<td>$ 490</td>
<td>$ 1,341</td>
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<tr>
<td>Multifamily</td>
<td>17</td>
<td>100</td>
<td>14</td>
<td>131</td>
</tr>
<tr>
<td>Total</td>
<td><strong>$ 74</strong></td>
<td><strong>$ 894</strong></td>
<td><strong>$ 504</strong></td>
<td><strong>$ 1,472</strong></td>
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</tbody>
</table>
### Single Family Variable Rate Economic Refunding Bonds

#### TABLE 2

**Amounts Outstanding at Semi-Annual Period in Millions**

<table>
<thead>
<tr>
<th>Issue</th>
<th>08/01/97</th>
<th>2/0</th>
<th>08/01/98</th>
<th>02/01/99</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>Totals</th>
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</thead>
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<td>1997 G</td>
<td></td>
<td>$49.6</td>
<td>.0</td>
<td></td>
<td>$J</td>
<td>$32.5</td>
<td>0.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998 M</td>
<td></td>
<td></td>
<td>66.5</td>
<td>53.7</td>
<td>52.0</td>
<td>43.4</td>
<td>42.4</td>
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<td></td>
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<tr>
<td>H</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>32.3</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999 I</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2</td>
<td>22.0</td>
<td>21.6</td>
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</tr>
<tr>
<td>J</td>
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<td></td>
<td></td>
<td></td>
<td>105.3</td>
<td>96.4</td>
<td>92.8</td>
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<tr>
<td>1999 P</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>25.1</td>
<td>24.5</td>
<td></td>
</tr>
<tr>
<td>1999 Q</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>26.5</td>
<td>26.3</td>
<td></td>
</tr>
<tr>
<td>2000 L</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>35.7</td>
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</tr>
<tr>
<td>2000 M</td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td>65.3</td>
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<tr>
<td>Totals</td>
<td>$53.0</td>
<td>$49.6</td>
<td>$12.4</td>
<td>$94.5</td>
<td>$250.5</td>
<td>$278.2</td>
<td>$370.1</td>
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</tbody>
</table>
HMRB 1997 Series G

Amounts Outstanding at Semi-Annual Periods

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount (Millions)</th>
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</thead>
<tbody>
<tr>
<td>08/01/97</td>
<td>53.0</td>
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<tr>
<td>02/01/98</td>
<td>49.6</td>
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<tr>
<td>08/01/98</td>
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<tr>
<td>02/01/99</td>
<td>41.9</td>
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<tr>
<td>08/01/99</td>
<td>35.5</td>
</tr>
<tr>
<td>02/01/00</td>
<td>32.5</td>
</tr>
<tr>
<td>08/01/00</td>
<td>30.3</td>
</tr>
</tbody>
</table>
### Relationship of HFA Economics to Interest Rates

<table>
<thead>
<tr>
<th>Direction of Interest Rates</th>
<th>Falling</th>
<th>Rising</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Annuity&quot; Value (1)</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>Real Estate Value (2)</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>Investment Returns (3)</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>Asset Growth (4)</td>
<td>↓</td>
<td>↑</td>
</tr>
</tbody>
</table>

(1) Includes both life and size of spread between loan rates and bond rates
(2) Assumes positive correlation between rate levels and real estate values
(3) Variable rate investments
(4) Assumes positive correlation between demand for HFA loans and interest rates
Changes in Residual Values at Various Interest Rates

Table 5

Tax-Exempt Short Term Rates at Historical Percentages of Taxable Short Term Rates

<table>
<thead>
<tr>
<th>Tax-Exempt Rate</th>
<th>3%</th>
<th>3.5%</th>
<th>4%</th>
<th>4.5%</th>
<th>5%</th>
<th>5.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Rate</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
<td>9%</td>
<td>10%</td>
</tr>
</tbody>
</table>

- Residual Value of HMRB Indenture
- Residual Value of HMRB Indenture plus Short Term Investments in State Investment Pool
Changes in Residual Values at Various Interest Rates (Continued)

TABLE 6

Tax-Exempt Short Term Rates same as Taxable Short Term Rates

<table>
<thead>
<tr>
<th>Tax-Exempt Rate</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Rate</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
<td>9%</td>
<td>10%</td>
</tr>
</tbody>
</table>

- Residual Value of HMRB Indenture

- Residual Value of HMRB Indenture plus Short Term Investments in State Investment Pool
2013

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July 7, 2000

Mr. Kenneth R. Carlson
Director of Financing
California Housing Finance Agency
1121 L Street, 7th Floor
Sacramento, CA 95814

Dear Mr. Carlson:

I wish to inform you that Moody's Rating Committee has confirmed the rating of Aa3 and has changed the outlook to positive from stable for the California Housing Finance Agency's Issuer Rating.

In assigning our rating, we relied on documents provided to us. In order to maintain our rating, we will require current financial and portfolio information on an ongoing basis.

If you have any questions regarding the rating or the information required to maintain the rating, please do not hesitate to contact me at (212) 553-3825.

Sincerely,

Susanne Forsyth

cc: David Notkin
Merrill Lynch & Co.
State Housing Finance Agencies Issue Increasing Amounts Of Variable Rate Debt

Additional Risks May Be offset By Strong HFA Management and Financial Strength

Summary opinion

- As the state housing finance agencies (HFAs) try to meet the increasing demand for their affordable mortgage loans, many have issued taxable bonds which are blended with tax exempt bonds to provide funds for mortgage loans. In an effort to reduce the interest costs of this debt and in a rising interest rate environment, a growing number of HFAs have issued variable rate debt.
- Given that the HFAs' portfolios are generally fixed rate loans, the mismatch between the fixed rate assets and the variable rate liabilities results in interest rate risk to the program. In addition, variable rate debt often offers a tender option to bondholders, which results in liquidity risks to the bond program.
- Variable rate bonds can be structured in various ways to offset or minimize exposure to the HFA. Liquidity facilities, such as Standby Bond Purchase Agreements (SBPA) can be used to address liquidity risks. Swaps and interest rate caps may also be utilized to offset some interest rate risk. HFAs must measure the cost and benefits of any structure, measuring the benefit of a higher risk structure against both the HFA's financial resources and tolerance to potential risks.
- Moody's will assess the risks of a variable rate bond through an analysis of the legal structure and stress cashflow projections. The cashflow scenarios must demonstrate that the quantified risks will be covered by active debt management and redemption, program revenues and/or HFA general obligation resources.

Scope of Article

This article will identify why state HFAs are issuing variable rate debt, describe the various types of variable rate debt structures that are currently being utilized, identify the risks of these structures and define Moody's approach to assessing these risks. It should also be noted that the variable rate municipal market is an evolving market. Moody's expects that as new structures and products are introduced and new information and trends are identified, Moody's approach will be modified.

Why State HFAs issue variable rate debt

There are several reasons for HFAs to issue variable rate debt, including more flexibility, lower costs of issuance and an expansion of buyers for the debt. Most state HFAs issue variable rate debt to lower the costs of their taxable bonds, utilizing swaps and other options to minimize costs. Many of the State HFAs face more demand for their mortgage
loans than is available under bond caps. To meet the demand, many have issued taxable debt that they blend with tax exempt bonds to offer below market mortgage loans. However, the pool of buyers for taxable housing bonds has been limited, as many taxable buyers look for more disclosure and less prepayment risk than the HFAs currently offer. To expand the universe and reduce the interest costs, many issuers issue variable rate bonds, which may be sold to a larger universe of bondholders, such as money market funds. As the variable rate market has become more popular in the housing arena, issuers have been using the product for tax exempt bonds as well.

Variable rate debt has also been used by HFAs as a hedge against their short-term investments. Some HFAs are required to invest their revenue or float funds in short term investments. Negative arbitrage may occur when short-term investments secure the long-term bonds. Issuers believe that they will be able to minimize or eliminate the negative arbitrage by issuing variable rate debt as the short-term investments will secure short-term bonds. Increases in the interest rate on the bonds will be payable by the increased interest rates on the investments.

Finally, some issuers use variable rate debt as a hedge against falling interest rates. Mortgage revenue bonds perform better in a higher interest rate environment as prepayments slow and therefore the loans stay outstanding longer earning more spread to the program. The HFA may issue some amount of variable rate debt to act as a hedge against lower interest rates.

**Variable Rate Risks**

The use of variable rate debt brings significant risks with its rewards. These risks can be broken down into two categories—liquidity and interest rate risk. These risks can be offset in a variety of ways. In the case of large liquidity needs, such as a bond tender option, the HFA can obtain a third party liquidity facility such as a Standby Bond Purchase Agreement (SBPA). In the case of interest rate risk, the HFA can use both external hedges such as swaps and interest rate caps and/or internal hedges, such as utilizing program excesses to cover the risk or setting aside HFA general obligation resources for potential program shortfalls. Each of these options comes with its own set of costs and risks. HFAs will determine whether the cost of these options offsets the benefit of the variable rate debt versus the fixed rate debt, and what level of risk the HFA is willing to be exposed to.

**Liquidity Risks**

Liquidity risk occurs because variable rate debt is generally short-term debt. As such variable rate debt often allows bondholders to tender the bonds to the issuer on an interest payment or reset date. The rate on the bonds is reset through a remarketing agent or the bonds may specify a set index calculation. Indexed bonds are generally repriced on a set schedule, based on a specific formula and index, e.g., LIBOR plus 10 basis points. In the case of an exercised tender option or a remarketing, bonds will generally be purchased by another investor, providing the funds to take out the previous owner. Although unlikely,
in the case of a failed remarketing, the Standby Bond Purchase Agreement (SBPA) stands by to provide the funds necessary to purchase the bonds and fulfill the HFAs obligation.

**Third party liquidity**

A SBPA is a liquidity facility from a third party, such as a bank, which provides a source of funds for meeting purchase price payments upon an optional or mandatory tender if the bonds cannot be remarketed to new investors on the tender date. Typically, the term of the liquidity facility is shorter than that of the bonds, and may be periodically extended or an alternate may be provided until the bonds are either converted to a fixed rate, mature or switch to auction rate. Moody’s assessment focuses on the credit quality of the liquidity provider as reflected in its rating from Moody’s, which must be at least P-1, and the legal structure of the agreement. For more information regarding these structures, please see "Moody’s Approach to Analyzing Insured Floater", December 1998.

**Structures with no liquidity**

Auction rate bonds have been used increasingly to provide greater flexibility in financing while limiting the cost and legal requirements of third party liquidity provider. This type of structure can be particularly beneficial as liquidity options become more expensive. Auction rate debt reprices at periodic intervals and are available in an Auction Period of seven, twenty-eight, thirty-five days and six-month intervals. The structure effectively offers the bondholder a put or mandatory tender feature and gives the bondholder liquidity without needing a designated liquidity facility, such as the SBPA. In the event of a failed remarketing the bondholder will earn interest rates based on predetermined index or price. This short term repricing may be beneficial during volatile interest rate environments, given the flexibility of the term.

**Interest Rate Risks**

Interest rate risk occurs in variable rate housing bonds because the mortgage assets are fixed rate and cannot be adjusted in accordance with the floating bond rate. If the bond rates increase to levels significantly above the interest rates on the assets then the program will incur negative arbitrage with the potential for a deficit. Interest rate risks can be controlled with either a swap or interest rate cap, or remain unhedged, using excess program revenue or HFA general obligation resources available to cover rising interest rates.

**Unhedged Debt**

Floating rate debt which is unhedged generally relies upon the strength of the State HFA’s program or unrestricted amounts to fund any debt service increases required from a change in interest rates. The variable rate is issued without a hedge from a swap, and so must rely upon a large stream of prepayments and/or excess revenues to payoff and call debt in the event of a significant interest rate increase.
As interest rates rise, Moody’s expects that HFAs will use their prepayments to call out these unhedged variable rate bonds first. Although prepayments will generally slow within a rising interest rate environment, this type of floating rate debt is usually issued as a small amount, generally 5-10%, under very large open indentures and may rely upon some minimum level of prepayment and significant excess revenues to call bonds early.

**Interest Rate Caps**

An interest rate cap allows the state HFA to pay the floating rate on the bonds but creates an upper limit to the cost of floating rate debt. The HFA enters an agreement with a bank or financial institution and the term for the cap, the reference rate, settlement dates, contract ceiling or maximum rate and the cap’s notional principal is contractually specified. The HFA pays the bank an up-front fee for the cap. If the reference rate exceeds the maximum rate while the cap is in place, the financial institution makes a payment to the HFA in the amount of the difference. This limits the HFA’s exposure to a the cap or maximum rate on the bonds.

The interest rate cap can be costly to the HFA, as the caps generally are paid for whether interest rates rise or not, and are not needed. The value, or expense, of the cap is impacted by, among other items, the length of the term covered, the current level of interest rates, the maximum rate, and the volatility and current level of the reference rate. Generally, the longer the term and the lower the cap rate, the more expensive the interest rate cap will be to the HFA. In addition, the cap rate will exceed current short-term rates and may still exceed the mortgage rate. Therefore, as in other unhedged debt, the program may still need to rely on program cashflow excess or prepayments in the event of rising interest rates up to the designated maximum rate. Given the potentially heavy exposure to rising interest rates in the case of unhedged or high maximum rate debt, Moody’s looks to various stress scenarios, which will be described below, to quantify necessary reserves.

Sidebar: **Creative Structures Allow HFAs Flexibility**

Recently, a structure was introduced which allows an HFA the flexibility of unhedged debt with the interest rate protection of a cap. This structure is a fixed rate swap with an embedded “knockout” option. The “knockout” option allows the counterparty the right to terminate the swap at par if the index averages above a certain level for a period of time (such as 6 months). These predetermined levels would be very high by historic standards. Under this option, the HFA would pay a lower fixed rate than in a comparable fixed rate swap without options. There would be no unwind or termination costs in the event of a termination. The risk to the HFA is that they would be paying a floating rate on the bonds if the swap were knocked out.

In conjunction with this swap an HFA could also own a series of “knock in” caps. These caps would cover a predetermined period and would be exercisable only if the underlying swap is knocked out. The knock in caps would be used at the discretion of the HFA and would protect them against spiking interest rates.
Interest Rate Swaps

Generally an HFA will issue floating rate debt and utilize an interest rate swap to minimize exposure to increases in interest rates. The HFA contracts with a highly rated swap provider or counterparty, to pay a sequence of fixed rate interest payments and to receive a sequence of floating rate interest payments. Although the principal bond amount will be used to calculate the interest payments, the principal is not actually exchanged and so the notional principal is used as a base for computing interest. The fixed rate is calculated at the time of issuance and the floating rate is tied to a standard index, such as the London Interbank Offered Rate (LIBOR) or Bond Market Association (BMA). The net payment, the difference between the floating and fixed calculation, is generally the only funds, which are transferred. Therefore, the HFA is responsible for an established fixed rate. If the rates remain below this fixed rate, the net payment to the counterparty is positive and the counterparty does not need to make any payments. If the rates are above the fixed rate, the net payment to the HFA is positive and the HFA does not need to make any payments.

Moody’s Approach to Assessing Variable Rate Risks

Swaps are structured transactions and can be tailored for each client. There are a number of risks associated with swaps. Depending on an HFA’s appetite for risk, a swap can be structured with more or less risk. Swaps which cover more risk are generally more expensive to the issuer and as such reduce some of the benefits of the variable rate debt. Although cashflow projections generally reflect the fixed payor amount for which the HFA is contractually responsible, other financial exposure must also be reviewed and can be represented in certain cashflow stress scenarios.

Risks Associated with Swaps May Be Mitigated If Quantified Accurately

Counterparty Risk – Financial Strength of Counterparty is Critical

The two parties in a swap must be certain of the credit worthiness of the other party. A credit deterioration, as indicated by a downgrade, generally below an A rating, will allow a termination. However, it is important to note that these terminations can be costly to the HFA regardless of the cause of the termination. The HFA may be required to make a payment to the counterparty even in a circumstance in which the counterparty unilaterally terminates the swap arrangement. Basically, the exposure to the HFA will depend, not upon the cause of the termination, but rather upon where rates are and whether the HFA is “in” or “out of the money”. Given the importance of the financial strength for both parties within the swap, the counterparty risk should be carefully evaluated. The Moody’s rating on the agreement provider must be sufficient to support the bond rating. Additionally, although the counterparty risk should be carefully evaluated, the “netting”
process for payments does mitigate some exposure, as the entire principal or notional amount is not held by the counterparty provider at any point.

**Basis Risk – Determined by Historical Relationship between Indices**

The floating rate payment provided by the swap counterparty may be based off an index that differs from the index that the bonds are floating off. For instance, a swap’s floating rate is often set at a predetermined percentage of LIBOR in order to achieve savings on the fixed rate payments made by the HFA. If the floating rate exempt bonds, which are tied to the BMA index, trade significantly above their historical relationship to LIBOR, the HFA will be responsible for any amount that the swap floating rate does not cover.

Moody’s reviews the historical performance of the two indices utilized to determine if and how much they have varied over time, and reviews the quantification of this exposure within the cashflow projections. Generally, the cashflow should reflect a stress in which the index used for the floating rate bonds rises above the historical average relationship and swap payments are not sufficient to cover the floating rate debt service. One of the most significant variables to impact this BMA/LIBOR relationship is the potential of change in the marginal tax rate, which is discussed below.

Additionally, given the remarketing component of many of these variable rate demand obligations, a stress of approximately ten basis points at each reset is often used to cover any discrepancies between where the bond is expected to trade and the relevant index.

**Amortization Mismatch Risk – Stressful Prepayment Scenarios are used to Quantify Risk**

Since the underlying mortgage assets are amortizing over time, some HFAs utilize an amortizing swap, in which the notional principal is reduced over time at a specified prepayment speed. This means that, generally, both the fixed and floating interest payments will become smaller during the life of the swap.

Although the amortizing swap will generally provide the necessary notional principal, a principal discrepancy can occur if the swap does not amortize at the expected prepayment or range of prepayments speed. A significantly lower prepayment speed will result in more bond principal remaining than expected and an insufficient swap amount to cover it. In this case, the HFA pays the counterparty the established fixed payment, but must also cover the floating rate costs of the portion of the debt that the swap no longer covers. In the event of rising interest rates this becomes a risk to the program. The mortgage revenue from the loan pool may not cover the floating rate on the bonds. The HFA, or the program is now responsible for covering this rate, given that the notional swap amount is not large enough to cover the outstanding bonds. The risk of slower prepayments is mitigated somewhat as HFA’s residual earnings often grow in value as mortgage prepayments slow.
Rapid loan prepayments also present risks to the HFA. The fixed payments on the swap are based on an established prepayment speed and may not be accelerated. In essence the swap obligation is often noncallable. If the loan prepayments are received more rapidly the HFA must do something with the prepaid funds until the swap may be paid off. Investing the money in the float fund is an option if the investment agreement permits it. This may or may not result in negative arbitrage depending on the interest rate of the investment agreement. Another option is using the prepayments to call out other bonds and relying on payments from other loans to pay off the swap. This option works better for large resolutions with a variety of loan and bond rates. The HFA may find it necessary to review the costs/benefits of a number of options, including a voluntary termination or “unwinding" of the swap. Although potentially expensive, the HFA may find unwinding a swap a viable alternative in a low interest rate environment, in which the HFA is "out of the money" and if prepayments are coming in faster than expected. Although the HFA will generally be responsible for the present value of the remaining swap payments, this may be preferable to the costs of negative arbitrage occurring on the accumulating prepayment amounts and the fixed payments that must be made off a notional swap amount which has not amortized at the same rate as the loan pool. This type of scenario may create an imbalance, in which the HFA’s fixed payments are being calculated off a notional swap amount which is significantly larger than the loan pool which is generating the revenues required to make the fixed payments.

Moody’s looks for cashflow stress scenarios to quantify these risks and for these risks to be covered by the program or the HFA’s unrestricted funds. Generally, a cashflow stress scenario will include the swap payments and notional amount and reflect both a rapid and slow prepayment speed. The extreme prepayment speeds are used in order to “break” the expected amortization and to quantify the HFA program funds, which may be needed to maintain the HFA’s obligations.

**Tax Rate Risk – Reduction In Marginal Tax Rate Creates Important Cashflow Stress Scenario**

Tax rate risk is applicable to swaps and their underlying assets on tax exempt bonds. The value of tax exempt bonds is fundamentally based upon the marginal tax rate. The higher the tax rate, the more valuable a tax-exempt bond is and the lower the interest rate may be on that bond. If the marginal tax rate is reduced, the spreads between tax exempt and taxable bonds narrows and tax exempt bond rates increase. Certain transactions, such as those which base the bond payment of BMA and the swap payment amount off LIBOR, pass on this tax rate risk to the issuer or the program. In the event of a change in the tax code that reduces marginal tax rates, the basis for the counterparty’s floating rate payment changes, shifting some of the higher interest rates back to the issuer. Moody’s reviews consolidated cash flow scenarios to demonstrate the impact on the program for those programs which utilize a large number of swaps.

Given the impact of a change in marginal tax rates on swaps and their underlying assets, Moody’s looks for a tax rate stress on those programs with a heavy utilization of swaps.
The tax rate stress generally assumes a decrease in the marginal tax rate within five years from the current marginal tax rate of 39.6% to approximately 25%. This stress builds on historical decreases in the marginal tax rate over the last thirty years and aids in quantifying the impact of a narrowing of the spread between tax exempt and taxable bonds.

**Cashflow Scenarios for Unhedged Variable Rate Debt**

Although Moody’s has utilized a very high or maximum rate cashflow stress on unhedged variable rate debt for programs with a small amount of floating rate debt, an alternative cashflow scenario may be utilized for programs with large variable rate issuance. These programs rely upon active debt management and redemption, excess program revenues and HFA reserves to cover interest rate exposure. Large issuance of variable rate debt requires a more realistic stress upon these reserves.

Moody’s will generally look for a cashflow scenario which ramps up the cashflow stress from the current interest rate to the “stress rate” over a period of five years. This stress rate will generally be approximately three standard deviations above the historical ten-year mean rate and is maintained at the stress rate for five years. In the case of LIBOR, this approximates a ramping up to a maximum stress rate of 11.58, and in the case of BMA a maximum stress rate of 7.5% is utilized. The stress rate is then ramped back down to the mean rate or mortgage rate, whichever is higher and held throughout the remainder of the bond life. It should be noted, that while these scenarios are based on data for the past ten years, the maximum rates that were chosen provide a strong degree of comfort (to the second standard deviation) for the data over the past 20 years.

In the case of a cap rate or maximum rate, the cashflows may reflect the lower of either the cap rate or the historical “stress rate”. This alternative cashflow scenario is intended to more closely incorporate historical interest rate stresses, and is in contrast to stressing the cashflow at the maximum rate over the entire bond life.
Glossary

Amortization Schedule: Any form of debt in which the principal balance is repaid gradually over the term of the loan. In the case of an amortizing swap, interest exchanges are made on a progressively smaller notional principal.

Bond cap: Tax Exempt bond issuance is federally limited by a private activity bond cap in issuance for housing, industrial development projects and student loans. The legislated 1986 limit provides for a state-by-state allotment of private activity bond issuance, currently at $50 per capita per state, with a minimum of $150 million per state.

Counterparty: The principal to a swap or other derivative product, contractually responsible for swap provisions.

Failed Remarketing: An event in which the bondholder exercises its tender option and the Remarketing Agent or Tender Agent is unable to remarket the variable rate bonds to new investors on the tender date.

Hedge: A position taken to offset risk associated with another position. Hedge positions often involve a risk management instrument such as a swap or futures contract.

Interest Rate Swap: An agreement between two parties to engage in a series of interest payments on the same notional principal denominated in the same currency, such as fixed-for-floating payments.

Liquidity Facility: Provides a source of funds for meeting purchase price payments upon an optional or mandatory tender in the case of a failed remarketing, generally provided by a standby bond purchase agreement (SBPA) or line of credit.

Marginal Tax rate: The legislated tax rate applied to the taxpayer’s last dollar of earnings.

Negative Arbitrage: The negative cashflow created from an earnings discrepancy between two securities. This includes the negative cashflow which may occur prior to loan origination, as bond proceeds temporarily invested in an investment agreement or Treasury may earn at a lower rate than the issued bonds.

Notional Principal: The amount of principal on which the interest is calculated on a swap or other instruments. In the case of interest rate swaps, the principal is purely notional in that no exchange of principal occurs.

Put: An option that grants its holder the right to sell the underlying asset, in this case the option of the bondholder to tender their bonds.
Spread: Multiple definitions including the number of basis points added to the Treasury yield curve to determine the absolute yield on swaps, and the differential between various indices.

Tender Option: The option of the security holder to tender the security for purchase to the Remarketing Agent or Tender Agent in accordance with defined provisions.

Termination Clause: Provisions in a swap agreement that provide for assessment of damages in the event of early swap termination.
Appendix A

**Marginal Tax Rates (Federal)**

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<th>Marginal tax rate</th>
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### Appendix B

**LIBOR & BMA Historical Data**

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<th>Mean-Normally Distributed</th>
<th>Mean</th>
<th>Maximum</th>
<th>Minimum</th>
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<td>BMA</td>
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<th>Minimum</th>
<th>Annualized Ln Norm Stdv</th>
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**BMA since 1989 (annualized)**

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<th>3st dev</th>
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<td>3.60</td>
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</table>

**LIBOR since 1989 (annualized)**

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<th>2st dev</th>
<th>3st dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.32</td>
<td>6.92</td>
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MEMORANDUM

To: Board of Directors

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: CaHLIF Financial Audit

The financial audit of CaHLIF, for the calendar year ending December 31, 1999, was recently completed by PricewaterhouseCoopers (PWC). The report of PWC to the Board of Directors regarding the financial statements is unqualified. In compliance with state statute, the financial statements and PWC’s report thereon will be compiled as a part of the financial statement supplement to the 1999-2000 CHFA Annual Report, which is planned for distribution to the Board of Directors in November.

Two additional reports relating to the financial audit were issued by PWC. The Report to Management on the Results of the 1999 Audit and their Annual Communications are attached.

In the Report to Management, PWC recommended that computer login passwords be lengthened to at least six characters and that user passwords be changed on a periodic basis. We have adopted this recommendation and the Information Technology Unit is currently implementing revised password protocols which include a password length of six characters and a user requirement to change passwords at least every 180 days.

In their Annual Communications to the Board of Directors, PWC advises that there were no significant audit adjustments, no disagreements with management and no audit difficulties encountered during the 1999 audit.

Attachments
California Housing Loan Insurance Fund
Report to Management on the Results of the 3999 Audit
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Board of Directors
California Housing Loan Insurance Fund
Sacramento, CA 95814

May 18, 2000

In planning and performing our audit of the California Housing Loan Insurance Fund (the Fund), for the year ended December 31, 1999, we considered the internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. Although our audits were not designed to provide assurance on the internal control structure, we noted certain matters involving the internal control structure and its operation, and are submitting for your consideration related recommendations designed to help management make improvements to current operations. Our comments reflect our desire to be of continuing assistance to the Fund.

The accompanying comments and recommendations are intended solely for the information and the use of management. This restriction is not intended to limit the distribution of this report, which upon acceptance by the Fund is a matter of public record.

Very truly yours,

PricewaterhouseCoopers LLP
A Password settings
We found the following items related to password security over the Unix system which contains critical applications and data:

- **No minimum** password length is enforced.
- **Users** are not required to periodically change their passwords.
- **Users are** not locked out of the system after repeated failed login attempts.
- **A user** was able to change the password to a bland password which had the effect of eliminating the system’s requirement of the user to enter a password to get access.

Recommendation
Strong password protocols decrease the risk that an intruder will gain access to the Unix system. We recommend the following enhancements be made to strengthen existing password controls:

- Set the minimum password length to at least six characters.
- Require users to change their passwords at least every 90 days.
- Disallow reuse of old passwords.
- Lock user accounts indefinitely after three failed login attempts.

Management’s Response
Management agrees with the recommendation that California Housing Finance Agency and the California Housing Loan Insurance Fund should increase security and control over computer login passwords. The recommendation will be implemented on all network servers (UNIX and Windows) effective July 1, 2000 with one variance. While the recommendation suggests that the passwords be changed every 90 days, management has decided that a time interval of 180 days is preferred. The following password protocols will be established:

- **Minimum** password length will be set to six characters
- **Users** will be required to change passwords at least every 180 days
- Reuse of old passwords will be disallowed
- **User accounts** will be locked out after three failed login attempts
California Housing Loan
Insurance Fund
Annual Communications
December 31, 1999
The purpose of this report is to apprise the Board of Directors of important matters related to our audit of the California Housing Loan Insurance Fund, for the year ended December 31, 1999. Professional auditing standards require that independent accountants communicate with the Board about certain matters that are likely to be important to the Board's oversight role. In the following section, we have provided commentary related to these communications. We will make ourselves available to discuss the results of our audit further at the request of the Board.

Auditor's Responsibility and Audit Report

Management is responsible for preparing the Fund's financial statements in accordance with accounting principles generally accepted in the United States. We are responsible for conducting an audit of the financial statements in accordance with auditing standards generally accepted in the United States. Under these standards, it is the objective of an audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement. We have completed our audit in accordance with our plan to provide professional services to the Fund.

Significant Accounting Policies

The significant accounting policies of the Fund are disclosed in the notes to the financial statements. There were no significant changes in accounting policies during 1999.

Management Judgments and Accounting Estimates

Management judgments and accounting estimates are an integral part of the financial statements prepared by management. Those judgments and estimates are based on knowledge and experience about past and current events and assumptions about future events. Significant estimates by management include determination of the loss and loss adjustment expense reserves and allowance of uncollectable loans. We performed various audit procedures related to these reserves and allowances. In addition to performing the various audit procedures, we used our actuarial personnel to consider the reasonableness of the loss reserves. The notes to the financial statements disclose the process used by management in determining an estimate for these reserves and allowances.

No Significant Audit Adjustments

As a result of our 1999 audit, we did not identify any transaction or event for which we proposed a significant adjustment. Also, we did not identify any potential adjustments which, by reason of immateriality, were not recorded by management.

No Disagreements With Management

There were no disagreements with management about accounting, auditing or disclosure matters.

No Consultations With Other Accountants

We are not aware of any consultations by management with other independent accountants.
| No Major Issues Discussed Prior To Appointment | There were no major issues, including the application of accounting principles, auditing standards or financial reporting, that were discussed with management in connection with our appointment as the Fund's independent accountants other than discussions regarding enhancing the methodology for determination of the loss reserves. |
| No Audit Difficulties | There were no significant difficulties encountered in performing our audit. Management and staff were very cooperative and helpful. |
MEMORANDUM

To: CHFA Board of Directors

Date: August 10, 2000

David N. Beaver
General Counsel

From: CALIFORNIA HOUSING FINANCE AGENCY

Subject: CHFA Director Tort Liability, Immunity and Indemnification

The following is a brief discussion of CHFA Director tort liability and immunity under state law. A "tort" is defined as a private or civil wrong or injury, other than breach of contract, for which the law provides a remedy in the form of damages. This memorandum also discusses a CHFA Director's right to indemnification by CHFA and the availability of insurance to cover any potential liability.

LIABILITY AND IMMUNITY

CHFA is a public instrumentality and political subdivision of the State of California and, as such, its directors fall within the definition of "public employee" under the California Tort Claims Act. A public employee is liable, except where otherwise provided by statute, for injury caused by his or her act or omission to the same extent as a private person, and is subject to any defense that would be available if he or she were a private person.

Because a CHFA Director is, to some degree, liable to the same extent as a private corporate director, any discussion of his or her liability should begin with a discussion of the liability of private corporate directors for corporate decisions. In California a private corporate director is required to perform his or her duties in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances. Generally, if a private corporate director performs his or her duty in accordance with these requirements, he or she will be shielded from personal liability for corporate decisions.

For the business judgment rule to apply, a director must act with the honest belief that the action being taken is in the best interests of the corporation. A director's interests may not conflict with those of the corporation nor may he or she have a material personal interest in a decision. For example, the business judgment rule does not protect a director who approves a corporate loan to a business entity in which he or she holds a financial interest.

The business judgment rule encompasses the concept of due care. "Due care" is essentially the expenditure of sufficient skill, time and effort to effectively uncover, examine and weigh the pertinent facts that must be assessed in order to make prudent decisions for the
management and supervision of the corporation. This includes the duty to make "reasonable inquiry" which requires a director who is put on notice by suspicious circumstances to make the same inquiry as an ordinary person would in similar circumstances, and clarifies that he or she may not avoid liability by merely closing his or her eyes to the situation. A director who ignores conspicuous danger signs and fails to investigate when circumstances warrant it is not protected by the business judgment rule. A director with special expertise (i.e., a lawyer or CPA) may be held to a higher standard of care with respect to transactions within his or her area of expertise.

In the course of discussing the propriety of forming a Finance Committee, CHFA Directors have recently questioned whether serving on such a committee might expose them to additional liability. A committee member may be exposed to liability beyond that of noncommittee directors of the board. At least one court has concluded that "...having injected themselves into the more detailed management of the corporation and thereby acquired additional knowledge, committee members are charged with that knowledge in judging their conduct. Their responsibility encompasses matters passed upon by the committee and as committee members and because of that participation, the diligence required of them is greater and the liability stricter." The assumption of duties that involve detailed supervision and greater access to company information increases the diligence requirements of committee members as compared to other directors of the board with respect to the particular functions of that committee.

It is unclear to what extent non-committee members are liable for the failure of a committee to perform its duties. Board members may not fulfill their responsibilities by simply delegating authority to a committee. Directors not serving on a committee must exercise reasonable care in monitoring the committee's work. In keeping with the primary purpose of board committees, a director not serving on a committee may rely on information, opinions, reports, or statements, including financial statements and other financial data, provided by the committee concerning matters within its designated authority." Nevertheless, the director's reliance must be in good faith. If the circumstances require it, the director must make his or her own reasonable inquiry into such matters.

Decisions which are outside the bounds of reason will not be protected by the business judgment rule. For example, one court found to be irrational, and thus not protected by the business judgment rule, a board's decision to sell a corporate subsidiary for $280 million less than its $760 million book value?

As previously stated, a CHFA Director is liable, except where otherwise provided by statute, for injury caused by his or her act or omission to the same extent as a private person. Fortunately, as public employees, CHFA Directors have the benefit of certain special statutory immunities which override liability they would otherwise have as a private corporate director.
The California Government Code provides various special immunities for public employees which are helpful shields against liability. Following are three such statutes which provide immunities of particular relevance to CHFA Directors:

3820.2 Except as otherwise provided by statute, a public employee is not liable for an injury resulting from his act or omission where the act or omission was the result of the exercise of the discretion vested in him, whether or not such discretion be abused.

3820.8 Except as otherwise provided by statute, a public employee is not liable for an injury caused by the act or omission of another person. Nothing in this section exonerates a public employee for liability for injury proximately caused by his own negligence or wrongful act or omission.

9822.2 A public employee acting in the scope of his employment is not liable for an injury caused by his misrepresentation, whether or not such misrepresentation be negligent or intentional, unless he is guilty of actual fraud, corruption or actual malice.

Government Code Section 820.2 provides that, when acting as such, a CHFA Director is immune from tort liability for discretionary acts. The words "Except as otherwise provided by statute . . ." in Section 820.2 refer to certain special statutory exceptions which have no applicability to CHFA Directors. Generally speaking, a "discretionary act" within the meaning of this immunity is an act which requires an exercise in judgment and choice, and involves an equitable decision of what is just and proper under the circumstances. In other words, discretion in the manner of performance of an act arises when the act may be performed in one of two ways, either of which would be lawful; and where it is left to the will or judgment of the performer to determine in which way it shall be performed.

Generally, an act is "ministerial" when it involves the doing of a certain thing that is unqualifiedly required. Where the law prescribes and defines the duties to be performed by the public employee with such precision and certainty as to leave nothing to the exercise of discretion or judgment, the act is ministerial. Since there is no discretion or judgment in the performance of a ministerial act, public employees are liable for their negligence in the performance of ministerial acts.

In a similar vein, even though there is immunity for a public employee exercising his or her discretion to undertake an act, there will be liability for his or her negligence in performing the act after having made a discretionary decision to do so.

In *Caldwell v Montoya* (1995) 10 C4th 972, 42 CR2d 842, the California Supreme Court unanimously held that Government Code Section 820.2 immunized school board members against a terminated school superintendent's claims of retaliatory discharge, and
race and age discrimination in violation of the California Fair Employment and Housing Act. The decision of an elected school board to replace the district's highest appointed official was held to be a "basic" governmental policy decision, entrusted to broad official judgment and protected by Section 820.2."

Factors crucial to the court's decision, and to a determination of discretionary immunity in general, include:

- The statutes governing the superintendent's employment indicated that discretion and sole authority were expressly entrusted to the board.

- The board's choice was a "sensitive and subjective one, with fundamental policy implications."

- There was a "vital public interest" in "encouraging both unfettered debate and judgment about the issue and candid public explanation by the politically accountable board members of the reasons for their votes," making judicial intervention inappropriate.

- Although the court found the requisite conscious balancing of risks and advantages by the board, it held that there was no requirement of a "strictly careful, thorough, formal, or correct evaluation." Such a requirement would "swallow an immunity designed to protect against claims of carelessness, malice, bad judgment, or abuse of discretion in the formulation of policy."

Government Code Section 820.8 makes it clear that one CHFA Director is not vicariously liable for the injury caused by the act or omission of any other CHFA Director nor any CHFA officer or staff member. A CHFA Director is only liable for his or her own wrongful act or omission. A Director might be liable, however, for the negligent supervision of staff. Again the words "Except as otherwise provided by statute. . ." in Section 820.8 refer to certain statutory exceptions which do not apply to CHFA Directors.

Government Code Section 822.2 provides that a CHFA Director is only liable for misrepresentation if he or she is guilty of actual fraud, corruption or actual malice. "Corruption" refers to the act of an official who wrongfully uses his position to procure some benefit for himself or herself or for another person, contrary to his or her duty and the rights of others. The adjective "actual" seems to be intended to distinguish between more ordinary fraud and malice characterized by something less than hostility, bad faith, or harmful intent (which is given immunity), and fraud and malice based on personal malevolence or wrongful purpose (which is not given immunity). Thus, in Schonfeld v City of Vallejo (1975) 50 CA3d 401, the court held that the immunity applies unless, in addition to elements of common law fraud, the public employee is "motivated by corruption or actual malice, i.e., a conscious intent to deceive, vex, annoy or harm the injured party in his business."
The above is a very general discussion of liability. There are two problem areas, however, which warrant special mention because they involve common scenarios which can expose CHFA Directors to criminal or civil liability, and/or possible loss of office. Those areas concern violations of the Director’s duty to disclose and avoid conflict of interest as set out in California Health & Safety Code Section 50904, and the open meeting requirements as set out in California Government Code Sections 11120, et seq. For example, should a CHFA Director have a financial interest in any matter before the board for a decision, that interest must be disclosed as a matter of the official public record. Also, that board member must not attempt to influence, participate in deliberations concerning, or vote as to that matter. Failure to make such a disclosure or an attempt to influence any such decision constitutes grounds for disqualification from office as a Director and is a misdemeanor.21 Similarly, failure to follow the open meeting laws, such as participating in closed deliberations concerning board matters or failing to follow the notice requirements of Section 11125 could expose a CHFA Director to possible criminal liability.22

INDEMNIFICATION

What if a CHFA Director is sued? Does CHFA have to provide for the defense? What if CHFA refuses? Does CHFA have to pay any judgment for damages or settlement of the case? If CHFA pays for the defense and/or any judgment or settlement, can it ultimately recoup these amounts from the Director?

If a CHFA Director is sued for actions or omissions arising out of his or her board activities, the Director must do two things, (1) make a request, not less than ten days before trial, for CHFA to provide the defense, and (2) reasonably cooperate, in good faith, in the defense.23 Assuming the Director does so, CHFA has the following options:

- Provide the defense unconditionally;
- Provide the defense, but conditioned upon a reservation of rights agreement with the Director; or
- Refuse to provide the defense.24

If CHFA provides the defense unconditionally, CHFA has an absolute duty to pay the costs of the defense, any judgment for damages (except punitive damages) and any compromise or settlement to which it agrees.25 CHFA must pay these amounts even if the Director was not acting within the scope of his or her employment at the time of the tort.26 By providing the defense unconditionally, CHFA also waives the right to recoup these amounts from the Director.27

If CHFA provides the defense, but conditioned upon a reservation of rights agreement, the following rules apply. The "reservation of rights agreement” means that the Director and CHFA agree that CHFA reserves the right not to pay any judgment, compromise or
settlement until the Director proves that the injury arose out of an act or omission which occurred within the scope of his or her employment, or (2) CHFA proves that the Director acted or failed to act because of "actual fraud, corruption or actual malice." See "Immunity and Liability" above for a discussion of "fraud, corruption or actual malice".

CHFA may refuse to provide the defense if it determines that (1) the alleged tort did not occur in the scope of the Director's employment; or (2) the Director acted or failed to act because of actual fraud, corruption or actual malice; or (3) the defense would create a "specific conflict of interest" between CHFA and the Director. If CHFA refuses to provide the defense, CHFA is still required to pay any judgment against the CHFA Director (except for punitive damages). After paying the judgment, CHFA is only permitted to recoup the amounts from the Director if it can prove that he or she acted or failed to act because of actual fraud, corruption or actual malice. That the Director may have been acting beyond the scope of his or her employment is not a basis for recouping costs from the Director in this situation. However, if the undefended Director seeks to recover attorney fees and other defense costs from CHFA, he or she must prove that the alleged tortious act or omission occurred in the scope of his or her employment.

If, for some reason, the CHFA Director pays a judgment against himself or herself, or a settlement or compromise of a claim, he or she is entitled to recover the amount from CHFA if (1) CHFA provided the defense unconditionally, or (2) the Director proves that he or she was acting within the scope of his or her employment and CHFA fails to prove that he or she committed actual fraud, corruption or actual malice.

CHFA is not obligated to pay any part of any claim or judgment that is for punitive damages? CHFA may only pay punitive damages imposed on a CHFA Director if it is approved by the California Legislature upon the recommendation of the authority that appointed the Director (i.e., the Governor in the case of CHFA Directors appointed by the Governor), and upon a determination by the Legislature and appointing power that:

- The judgment was based on an act or omission of the Director while acting in the course and scope of his or her employment as a CHFA Director;
- The Director acted or failed to act, in good faith, without actual malice and in the apparent best interest of CHFA; and
- Payment would be in the best interest of CHFA.

Again, the above is a very brief summary of the issues surrounding CHFA Director liability, immunity and rights to indemnification, and is not intended to be a comprehensive study or analysis of the topics covered herein. Obviously, should you have particular questions regarding any of the issues addressed herein, you should contact the CHFA Office of General Counsel for further clarification.
LIABILITY INSURANCE

It is common for private corporate directors to be covered by Directors and Officers ("D&O") liability insurance. D&O liability insurance is a form of malpractice insurance, designed to protect directors against personal liability (and from incurring defense costs) in lawsuits brought against them in their capacities as directors. It may also insure the corporation against the costs associated with the defense of such suits or the indemnification of its directors.

California Law contains broad and flexible authority for CHFA to insure against tort liability by purchasing commercial liability insurance, by self-insurance, or by a combination of these means. The insurance may protect against all or any part of a Director's personal liability for injury resulting from an act or omission in the scope of his or her employment or the expense of defending a claim against CHFA or the Director whether or not liability exists on such claim, including claims seeking punitive damages. The insurance authority granted by these statutes includes coverage for both negligent and intentional torts, although it is doubtful that such insurance is available to pay punitive damages liability (although it probably would cover the costs of defending the punitive damages claims).36

Staff is currently in the process of obtaining information about the availability, extent of coverage and cost of obtaining D&O insurance to cover CHFA Director liability. We have submitted an application to Dan Howell of Driver Risk Services, who is the insurance broker designated by the California Department of General Services with respect to this type of coverage. If the Board so desires, Mr. Howell is available to make a presentation to the Board about this insurance on a later date.

Endnotes

2. Claims based on breach of contract, constitutional violations or federal statutory rights are beyond the scope of this discussion of liability and immunity, however, CHFA's duty of indemnification does apply to claims based on the federal Civil Rights Act.
5. California Corporations Code Section 309(a).
7. ADCDO, Section 3.4.
8. ADCDO, Section 5.7; Syracuse Television, Inc. v Channel 9, Syracuse, Inc. (1966) 273 NYS2d 16.
9. ADCDO, Section 5.8; Gaillard v Natomas Co. (1989) 208 CA3d 1250,256 CR 702.
10. ADCDO Section 5.8; ABA Section of Business Law, Corporate Director's Guidebook, 49 Bus Law 1247 (May 1994).

11. ADCDO. Section 5.8; Corporations Code Section 309(b)(3).

12. ADCDO. Section 5.8; Corporations Code Section 309(b); Gaillard v. Natomas Co.

13. ADCDO, Section 3.21; Gimbel v. Signal Cos., (Del Ch 1974) 316 A2d 599.


23. CGTLP, Section 4.14; Government Code Section 825(a).

24. CGTLP, Sections 4.1 + 4.12; Government Code Section 995 and 995.2.

25. CGTLP, Sections 4.7 and 4.18; Government Code Sections 996 and 825(a).

26. CGTLP, Section 4.7 and 4.18.

27. CGTLP, Section 4.18.

28. CGTLP, Section 4.20 Government Code Section 825(a).

29. CGTLP, Sections 4.9 and 4.19; Government Code Sections 825(a), 995.2 - 995.8.

30. CGTLP, Section 4.19.

31. CGTLP, Section 4.19.

32. CGTLP, Section 4.19.

33. CGTLP, Section 4.21; Government Code Section 825.2.

34. CGTLP, Section 4.15; Government Code Section 825(a).

35. CGTLP, Section 4.15; Government Code Section 825(b).

36. CGTLP, Section 9.36; Government Code Section 11007.4.