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OVERSIGHT OF THE FEDERAL HOME LOAN BANK SYSTEM

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE OPERATIONS OF THE FEDERAL HOME LOAN BANK SYSTEM, FOCUSING ON THE RESPONSIBILITY THAT CONGRESS HAS PLACED WITH THE FEDERAL HOME LOAN BANKS TO ENHANCE THE LIQUIDITY OF FINANCIAL INSTITUTIONS, PARTICULARLY AS THE FEDERAL HOME LOAN BANK MEMBERS MEET SUCH COMMUNITY NEEDS AS PROMOTING HOMEOWNERSHIP

SEPTEMBER 9, 2003

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OVERSIGHT OF THE FEDERAL HOME LOAN BANK SYSTEM

TUESDAY, SEPTEMBER 9, 2003

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:05 p.m., in room SD–538, Dirksen Senate Office Building, Senator Robert F. Bennett (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. The hearing will come to order. We appreciate the witnesses' being here and look forward to hearing their testimony, and making this a worthwhile hearing.

One of the fundamental roles of Congress and this Subcommittee is to provide periodic oversight, and that is why we are here today. We have no specific legislation before us. But it has been a considerable amount of time since Congress or the Banking Committee has held an oversight hearing on the Home Loan Bank System, and we recognize that periodic oversight helps keep houses in order.

President Eisenhower, when he was a general, used to say that areas that are not periodically inspected tend to deteriorate. Those of us who have been in the military know what periodic inspections are like, and we do not want to make this hearing quite like that.

This is not to say that this particular house is not in order or that it has tended to deteriorate. But we have not looked at any part of the Home Loan Bank System since Gramm-Leach-Bliley where we made adjustments to the membership rules, collateral options for advances, and the capital requirements of the System. Since Gramm-Leach-Bliley, our banking and finance system has continued to evolve to meet the demands of an important and ever changing marketplace.

We have had consolidations that have brought efficiencies and synergies that have undoubtedly played a major part in the sustained success we have been experiencing in the housing and housing financing market. I believe the Home Loan Banks, along with the other housing GSE's, have played a vital role in funding this growth.

My own State of Utah is a net borrower. Utah's future housing growth and economic vitality depends upon the capital that can come partly from Home Loan Banks and others that can access Wall Street and bring investment to my State. The role of the

Home Loan Banks and other housing GSE's play in communities across the Nation is, in my opinion, invaluable.

We are currently experiencing what I hope, and still believe, is just a hiccup in our housing GSE system, but given the importance of the housing finance system and the billions of dollars that move daily through the GSE's from investors all around the world and then into our communities, even this little hiccup requires Congress to act to ensure that safety and soundness and the confidence of the markets in the GSE system is maintained and, we would hope, be even strengthened.

This is a good time for Congress to take a look at the entire system, and while this Subcommittee does not have jurisdiction over all of the GSE's, we do have the responsibility for the Federal Home Loan Banks, and that is why we are concentrating there today.

Since Gramm-Leach-Bliley, several issues have emerged in the Home Loan Bank System that Congress has not reviewed, and these issues relate directly to safety and soundness and the mission of the System. So we will begin to create a record on these issues here this afternoon.

The issues are: one, whether or not the Home Loan Banks should register with the SEC; two, whether or not a member institution of the System should be permitted to be a member of more than one regional Home Loan Bank; three, at what level should the Home Loan Banks be permitted to participate in the secondary mortgage market; and, four, whether or not we should have a single regulator for all of the housing GSE's. And all of these issues are closely related to the safety and soundness and the mission of the System.

I understand, to put it somewhat mildly, that these issue remain unagreed upon, both inside and outside the System, and I believe that all would agree that each of them could have a major impact on housing finance, homeownership costs, and, therefore, the economy, particularly the economy at this point where housing has led the recovery. That usually is not the case. Housing is usually the last thing to recover. But in this very unusual recession and recover, housing has been one of the strongest parts. That is another reason why we need to pay attention.

In bringing up the final question of whether Congress should create a single regulator for all of the GSE's, I want to make sure that I acknowledge the efforts of Chairman Korsmo. Mr. Chairman, you have put forth tremendous effort to strengthen the regulation of each institution individually as well as the System as a whole through a more thorough examination regime, and I congratulate you for that.

Mr. KORSMO. Thank you, sir.

Senator BENNETT. Regardless of the quality of regulation, there are those who believe that all the housing GSE's should operate under a coordinated regulator with appropriate authority, believing that separate can never be equal, at least in perception of the markets. I will continue to reserve judgment on that, but we are going to hear from Treasury Secretary Snow tomorrow before the House. I expect he will address that issue, and we will look at his testimony with great interest.

Secretary Abernathy, we welcome you back to the Committee, where you served so ably for such a long period of time. I suspect you will feel the same way and reserve judgment until after your boss has spoken. But if you want to surprise us——

[Laughter.]

—we would be happy to have you surprise us.

Senator Johnson, I appreciate very much your attendance, not only at this hearing but your diligence in this issue in the past, and we would be delighted to hear from you.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Chairman Bennett, and welcome to Secretary Abernathy and Mr. Korsmo. I thank you, Mr. Chairman, for holding this afternoon's hearing on oversight of the Federal Home Loan Bank System. I cannot think of a more timely hearing given recent attention on Government Sponsored Enterprises and debate over the nature and scope of their regulatory agency.

Today is a good opportunity to take stock of the role, mission, and regulation of the Home Loan Banking System. I apologize in advance if my schedule will not allow me to stay for the entire hearing. As usual, I have competing and overlapping obligations, and I know that we are in good hands under your leadership.

The Federal Home Loan Banks play a critical role in our Nation's housing finance and community lending system. Since the Home Loan Banks were created in 1932 with the mission of helping to make homeownership more affordable, the positive impact and the mission of the Bank has grown significantly.

In my State of South Dakota, the Home Loan Banking System has provided critical funding for community lending needs. Until a recent flight to safety of financial assets, our small community banks faced serious funding issues, related in part to the continued erosion in the value of deposit insurance. The Home Loan Banks provided advanced services to counteract those funding shortfall, ensuring that South Dakota consumers had access to loans that they needed to keep our rural areas economically viable.

I should also note that since 1990, South Dakota has received $8.6 million from the Federal Home Loan Bank of Des Moines' affordable housing program. This investment has assisted 66 affordable housing projects throughout our State.

Mr. Chairman, today's hearing is also well-timed because it is not in response to a crisis. The Committee has important responsibility to conduct regular oversight, and this is especially important with respect to the Federal Home Loan Banking System because of the central role that it plays in today's financial marketplace. Few would dispute that the Banks play a different role than they did back in the 1930's. Some do, however, dispute whether these new activities fall within the proper mission of the Banks. That is a legitimate question. I am pleased we will have a chance to hear from a variety of witnesses today.

In addition, we should also consider whether the Federal Housing Finance Board has the tools it needs to regulate what have become increasingly complex and sophisticated financial institutions. At least one witness has advocated that the Home Loan Banks

share a regulator with the other housing GSE's. This hearing could not be better timed to hear both sides of that debate as we move toward consideration of possible changes in the regulation of Fannie Mae and Freddie Mac.

Finally, some of us here have had the chance to hear from SEC Chairman Donaldson this morning about the implementation of Sarbanes-Oxley. I hope that the witnesses will describe for the Subcommittee their experience with any corporate governance reforms and their position on disclosure proposals currently under discussion.

Chairman Bennett, thank you for holding today's hearing, and I look forward to hearing from these excellent witnesses.

Senator BENNETT. Thank you very much.

Secretary Abernathy, we will start with you.

STATEMENT OF WAYNE A. ABERNATHY
ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS
U.S. DEPARTMENT OF THE TREASURY

Mr. ABERNATHY. Thank you, Mr. Chairman, Senator Johnson, Members of the Subcommittee. Thank you for this opportunity to testify this afternoon on the Federal Home Loan Bank System. I would like to focus on three topics this afternoon: First, the need for the Federal Home Loans Banks to register with the Securities and Exchange Commission under the terms of the Securities Exchange Act of 1934; second, I would like to talk about multidistrict membership; and, third, Treasury's current review of the Federal Home Loan Bank System.

The observance of good, fundamental practices of corporate governance is a high priority for this Administration. For more than a year, the Administration has been urging that all GSE's comply with the same corporate disclosure requirements of the Securities Exchange Act of 1934. We are pleased that Fannie Mae has complied with this request. Freddie Mac has also agreed, though we are disappointed to learn that Freddie Mac may not be registering until sometime in 2004. The sooner they register, the better.

The Administration has continued to urge that the Federal Home Loan Banks also move forward with voluntary registration. Some have argued that the unique characteristics of the Banks lessen the need for registration under the 1934 Act. All of these facts are important and must be, and I believe can be, taken into account.

However, the differences do not change the fundamental fact that the Home Loan Banks are significant participants in our capital markets. Investors should have the same information regarding the condition of the Home Loan Banks as they have for other significant participants in the capital markets.

At the end of June, the Federal Home Loan Banks had outstanding consolidated obligations of $713 billion. The individual Banks are each large financial institutions. As of year-end 2002, the largest Bank, the Bank of San Francisco, had $135 billion in total assets. The smallest, the Bank of Topeka, had $33 billion in total assets, while the average was $58 billion in total assets. Even the smallest would rank among the top 40 commercial banks in the United States.

Investors would benefit from the added oversight of the SEC, both in terms of reviewing financial disclosures and through uniform enforcement of current standards. And investors would have a basis for making comparable evaluations of the variety of institutions that are competing for their investment dollars. Our system of securities regulation should offer investors nothing short of that standard.

The continued operation of the Banks outside of the SEC-administered corporate disclosure regime is inconsistent with our objectives of a sound and resilient financial system. We understand that the Banks have some remaining concerns with how certain aspects of their business operation would be treated. I would remind all concerned that the Federal Home Loan Banks are not the only corporate institutions in America that have unique characteristics. Given the flexibilities that the SEC has to address individual circumstances, we are confident that the Banks' concerns can be worked out.

We appreciate the discussions that several of the Banks have had with the SEC earlier this year, and we look forward to these discussions being renewed in the immediate future, within a context of acceptance of the public interest that would be served by the Federal Home Loan Banks registering under the 1934 Act.

We understand that the Board of Directors of the Bank of Cincinnati recently announced that the Bank will be taking the next step in the process. In a recent letter to Secretary Snow, HUD Secretary Martinez, and Chairman Korsmo, the Board of Directors of the Federal Home Loan Bank of San Francisco expressed their goal "to enable the Federal Home Loan Banks to become role models for corporate transparency." That is our goal as well, to which registration under the Securities Exchange Act of 1934 is essential.

Let me just talk about multidistrict membership, in context. While there continues to be debate over a number of Home Loan Bank activities, one current issue, the question of multidistrict membership, raises particular concern. The appropriate forum for the resolution of this issue must be kept in mind. As the Treasury Department has written in a comment letter to the Finance Board, regardless of whether allowing multidistrict membership is wise, a plain reading of the statute finds little room to conclude that the Finance Board has the legal authority to approve it. It provides, and I quote from the statute,

> An institution eligible to become a member under this section may become a member only of, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's principal place of business, or of the Bank of a district adjoining such district, if demanded by convenience and then only with the approval of the Board.

I have played with that language many times trying to make sure how does that "or" work, and I have thought of it in terms of my children at home. I can say to my son, "You may have your army toys in your room or you may have it in the playroom." To my mind, that is one room. If I wanted to say it could be either one of those two and both of them, I would say, "You can have your toys in your room and the playroom." But if I use an "or," it brings into my mind there is only one place where those are going to be

located. The statute provides for an "or," and it seems pretty clear to us.

Now, to say this is not to render a policy point of view. There are compelling arguments on both sides of the question. Clearly, our financial system has changed dramatically since 1932. In the intervening years, however, Congress has revised the governing statutes on several occasions. But they have never changed that particular requirement. It is to the Congress that these arguments should be offered and where any change in the statute will have to be made.

The third point I would like to raise. Earlier this year, I requested the Office of Financial Institutions Policy at Treasury to conduct an in-house review of the Federal Home Loan Bank System, with particular but not exclusive, consideration of the effect of the changes enacted as part of the Gramm-Leach-Bliley Act of 1999. As I announced at that time, the review would consider the following points: how these changes have affected the ability of the Federal Home Loan Banks to meet their statutory mission; implications for the financial strength of the Banks individually and the System in general; how the business operations of the Banks contribute to accomplishing their statutory mission; issues regarding governance structure and management, including executive compensation; effect of new capital structures on operations; and other issues regarding the strength of the System and the structure of Federal oversight.

We are now about 4 months into that process, nearing completion of our first phase. Again, I would like to emphasize that Treasury's review of the Federal Home Loan Bank System is part of what we normally do at Treasury, and what I envision for our current review is a more specific look at how the changes made to the Federal Home Loan Bank System as part of the GLBA have been implemented. Treasury is not primarily a regulatory agency. We see as part of our important function, however, providing executive branch oversight of the activities of the independent financial regulators, and this study is part of meeting that obligation and responsibility.

The Federal Home Loan Bank System presents policymakers with issues that deserve continued attention. We must continue to evaluate the System to ensure that it is achieving the objectives set forth by Congress, meeting the needs of our communities that might not be otherwise met.

Thank you again for providing me this opportunity to present our views before you today and to discuss these important issues, and I would be glad to answer any questions.

Senator BENNETT. Thank you very much for your testimony.

Chairman Korsmo, we appreciate your being here and look forward to hearing from you.

STATEMENT OF JOHN T. KORSMO
CHAIRMAN, FEDERAL HOUSING FINANCE BOARD

Mr. KORSMO. Thank you, Chairman Bennett, Ranking Member Johnson, and distinguished Members of the Subcommittee, I appreciate the opportunity to speak with you today about the Federal Housing Finance Board and the Federal Home Loan Bank System.

I have a brief opening statement, but I have also brought prepared testimony with more thorough discussion of several key topics affecting the Federal Home Loan Banks I have been asked to address.

Senator BENNETT. Without objection, your testimony shall appear in the record.

Mr. KORSMO. Thank you, Mr. Chairman.

Many important issues are facing the Nation's Government Sponsored Enterprises, including, certainly, the Federal Home Loan Banks. In the interest of time, I highlight the aggressive steps we have taken at the Federal Housing Finance Board, the System's regulator, first, to strengthen the agency's oversight capabilities and, second, to improve financial disclosures by the Federal Home Loan Banks through voluntary registration with the Securities and Exchange Commission.

These initiatives will benefit not just the Federal Home Loan Banks and their more than 8,000 member institutions, but also the investors who purchase their debt, and ultimately the homebuying public and the taxpayers.

Soon after President Bush named me Chairman in December 2001, I determined that the Finance Board lacked many of the necessary resources to effectively oversee the Federal Home Loan Banks for safety and soundness and achievement of their housing finance mission. Just one example demonstrates this point. At the time, the Finance Board had only eight bank examiners on staff to review and supervise 12 financial institutions with, at the time, more than $700 billion in assets, more than $30 billion in capital, and some $650 billion in outstanding debt. Yet, at the same time, the agency had eight people in its Office of Public Affairs. The relative allocation of resources simply did not meet the agency's statutory mandates.

I immediately addressed these problems beginning with the recruitment of new leadership for the agency's Office of Supervision. After a national search, the Finance Board hired a new Director and a new Deputy Director of Supervision, who, between them, have 40 years of Federal bank regulatory experience.

Mr. Chairman, I appreciate your comments about the improvements we have made in our supervisory and examination function. I should say that while often much is made of the times that my Finance Board colleagues and I do not agree, on this issue, as on most issues, my colleagues deserve equal credit for our initiatives in this area. My fellow Finance Board members and I acting together increased the resources available for supervision, expanding our examination staff to 17 full-time examiners. Our goal is to have 24 in place by the end of this calendar year and 30 by the end of the next budget year.

We are now conducting more thorough examinations, focusing on the Banks' risk assessment processes, internal control systems, and systems of corporate governance. And we are communicating the results of those examinations more effectively to the Banks. Now our examinations recognize that banking, even AAA-rated, GSE banking, is a business of managing risks, and the responsibility of bank supervisors is to ensure that the institutions they regulate

understand those risks and that they monitor and control them through prudent practices.

On the subject of enhanced financial disclosures, last summer I formed a working group with the Finance Board and the Federal Home Loan Banks to review the issues associated with voluntary registration of the Banks with the Securities and Exchange Commission.

Earlier this year, I concluded that voluntary registration is indeed the best approach to enhancing public disclosure of the governance and finances of these important institutions. I reached this conclusion based on two premises.

First, the Banks' long-term access to global capital markets will be enhanced by providing investors in consolidated obligations with maximum reliable transparency into the finances and governance of each of the 12 Banks. Markets function best, especially in times of stress, when needed information is readily available and reliable.

Second, as public trusts, these 12 GSE's have a duty to contribute both to the smooth functioning of capital and mortgage finance markets and to public confidence that the benefits of GSE status are used wisely.

The Federal Home Loan Banks and the staff of the SEC have held numerous meetings to address the process for voluntary registration. In fact, another meeting was held only yesterday. It is now time, I believe, to bring this process to a positive conclusion.

I note that this summer the boards of the Federal Home Loan Bank of San Francisco and the Federal Home Loan Bank of Atlanta, as Secretary Abernathy mentioned, resolved that if SEC registration was the determined course of action, then the Federal Housing Finance Board should adopt a regulation requiring it.

In response to those requests, tomorrow at our regularly scheduled meeting the Federal Housing Finance Board will consider a proposed regulation requiring the Banks to register a class of their securities with the SEC.

The proposed rule provides for a lengthy, 120-day comment period, during which, I hope, the Banks will each meet with the SEC to work out the necessary details to effectuate registration and begin meeting the periodic financial reporting requirements of the 1934 Act.

Mr. Chairman, distinguished Members of the Subcommittee, I focused on these two areas of safety and soundness oversight and improved financial disclosures because of their importance to the strength and resiliency of the Federal Home Loan Banks. Certainly we are dealing with many other issues at the Finance Board, which are addressed in my written testimony, and I welcome the opportunity to discuss any and all of them with you.

Thank you again for your time this afternoon. I look forward to addressing your questions.

Senator BENNETT. Thank you very much.

The Federal Home Loan Bank System has traditionally focused on providing advances to their members. In the last couple of years, Home Loan Banks have initiated a program of directly acquiring loans from their members. At what level should the Home Loan Banks participate in the secondary market in this way, in

your opinion? And should securitization be considered as an option for the Banks?

Do either one of you want to go first on that question?

Mr. ABERNATHY. I am happy to proceed, Mr. Chairman. Let me deal with the securitization issue first, if I may.

Senator BENNETT. Certainly.

Mr. ABERNATHY. I think it is important to understand the nature of the Federal Home Loan Bank System as a cooperative system. It is different than a lot of other systems. They were put together as a cooperative system. The Banks are owned by their members. They are governed by their members. The Banks have this joint and several liability responsibility to shore up and assist each of the other members.

I think that is important to keep in mind when you are looking at the question of securitization. These institutions were created to serve their membership, and in our view, anything that would suggest that they should be securitizing something for sale outside of that membership is something that is outside of the concept of the Federal Home Loan Bank System as it is presently constituted.

On the other hand, I think with regard to some of the innovative programs that have been established that are currently in operation, those are all kept within the System. They provide an important source of liquidity to the member banks, and by that I mean the member banks of the Federal Home Loan Bank System, the ones that are members of each of the Home Loan Banks. And as far as we can see, they are providing an important service both with regard to the individual banks and the people who are most impacted, the people who take out the mortgages and buy and sell their homes based upon that financing.

Mr. KORSMO. Mr. Chairman, do you want me to respond?

Senator BENNETT. Yes.

Mr. KORSMO. Secretary Abernathy has outlined the concerns in the larger context very well. I think it is appropriate to mention that right now Federal Housing Finance Board regulations do not permit Federal Home Loan Banks to issue or guarantee mortgage-backed securities. There has been no request from any Bank or from any Bank's Board of Directors to seek such approval.

I think if the question does come before us, obviously we will have to look at the whole question of legal authority and the safety and soundness basis for making a judgment. I do not know if there is anything more to say about that at this point, but that goes to the point of your question.

Senator BENNETT. I want to go back to the first part of my question. At what level should the Banks participate in the secondary market in this way? Because, again, traditionally, as you pointed out, Secretary Abernathy, the Banks exist to serve their members. Now they have gone in the direction of acquiring loans from the members as opposed to making advances to the members. And is there a financial level for this activity that would raise any concern on your part, or do you assume that that would be fine and this is where we go?

Mr. ABERNATHY. Well, I think perhaps the most flexible definition of how far they should go would be how far their capital and resources can appropriately finance the risk that would be involved

with purchasing the mortgages from their entities. But so far, the requirements for purchasing the mortgages from their member banks has been that the mortgages must be just as good as if they were being held for collateral, in which case it is difficult to say that they are taking on much more of a risk than they would by holding these merely as collateral.

I think that is an important requirement, that the quality of the loans they purchase be of a high level so that they can manage that risk appropriately.

Senator BENNETT. Looking ahead to the debate as to whether or not they should be allowed to compete directly with Fannie Mae and Freddie Mac, is that the same level of safety that is required for Fannie and Freddie?

Mr. KORSMO. In fact, sir, I would argue it is higher. The risk-based capital standards under which the Federal Home Loan Banks act are actually higher. I think Secretary Abernathy is right in portraying this particular aspect of the Banks' function, which is indeed providing more direct liquidity for mortgage lending. Advances, of course, are fungible, and to some extent, while they have to be collateralized with approved collateral that meets the standards of our regulations, the reality is that while advances remain by far the most significant aspect of Federal Home Loan Bank portfolios, the growth of acquired member asset programs truly reflect a member need.

Senator BENNETT. Okay. Quickly, because my time has expired, but I want to follow up before we have lost the thought. Assuming that you are correct that the standard for a Home Loan Bank is higher than the standard for the other GSE's, does that mean if you get into direct competition that in the Home Loan Bank System they would like to lower the standard to that that exists with Fannie and Freddie?

Mr. ABERNATHY. I think there is direct competition. I think everybody recognized that when they made their most recent filing with the SEC. They listed who their competitors were, and they indicated they are the Federal Home Loan Banks. But they are a competition at a certain level. It is a competition for those higher quality——

Senator BENNETT. Yes. At a certain level do we see——

Mr. ABERNATHY. In a different form, I should mention.

Senator BENNETT. Would we see a lowering of the standard that you have just described? Do you think that is going to happen?

Mr. KORSMO. I would certainly hope not. That would not be the view of this regulator, anyway, to permit it, and right now the statute would not.

Mr. ABERNATHY. I think there is a certain value in making sure that the mortgages purchased are very similar to the collateral requirements.

Senator BENNETT. Okay. Thank you.

Senator Johnson has left, so, Senator Corzine, you came in next on the minority side. We will turn to you.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, for holding this important and timely hearing.

I guess I have to ask the following question: What is the basis to say that the standards of the Home Loan Bank are superior to the ones for other GSE's? Is it a risk-based model? Does it take into account the prepayment exposures and convects the exposures that are so difficult to manage in all financial institutions, in my perspective? And, second, what type of off-balance-sheet exposures, if any, letters of credit or other forms, exist in the Home Loan Bank System? And how can we be certain that those are factored into the risk-based models?

Mr. KORSMO. Certainly, sir, I am not exactly sure where to start on that question, but certainly we could assure you that the oversight that we provide and the constraints that the regulatory environment that we have created or the Finance Board has created are extremely strict. These are very conservative institutions. They are driven by a very conservative model and driven by, as I mentioned, a very conservative regulatory structure.

Senator CORZINE. Was the Treasury prepared to make that——

Mr. ABERNATHY. I do not know that I would have phrased it the same way as Chairman Korsmo with regard to the Federal Home Loan Banks having a higher quality of portfolio. Fannie and Freddie were created particularly to establish secondary markets, and their mandate is broader. They are required to go into more markets than the Federal Home Loan Banks are. Because the Federal Home Loan Banks are required to have a very high level of collateral for the advances they give, and their program was designed to match that standard with regard to the loans they purchase, they are only targeting a certain segment of the home mortgage market.

Fannie and Freddie were required to address a much broader range, in fact, with a particular emphasis on middle to lower income. And so because of that you would expect that they would be taking on what might be considered riskier mortgages, but they also have hedging and other types of strategies to manage that risk. And so as institutions, I would not like to have on the record the concept that Fannie and Freddie are riskier institutions than the Federal Home Loan Banks. They are required to have a broader portfolio, I think is the point I would make.

Mr. KORSMO. I would certainly agree with that, but I would mention that the leverage requirements of our risk-based capital regulation are higher in the sense that we have a 4-percent leverage requirement versus the 2.5 that applies, I believe, to Fannie and Freddie. I really am not terribly familiar with the Fannie and Freddie model, frankly.

Senator CORZINE. They have a minimum of 2.5, and then they have a risk-based standard.

Mr. KORSMO. Right, exactly.

Senator CORZINE. As an add-on.

Mr. KORSMO. You also asked about off-balance-sheet items. Our regulations require that derivatives be used only for hedging. Federal Home Loan Banks cannot use them for investment purposes. Eighty-two percent of the derivative use makes a perfect match with advances in consolidated obligations. So, again, I think the short answer is that the regulatory environment that we have created is very strict, and I think there is no question about that these

institutions operate in a very high plane in terms of safety and soundness, which, after all, is our primary mission as the Federal Housing Finance Board.

Senator CORZINE. As an individual that has looked at risk-based models off and on, it is hard to know, except through practical experience through time and different stresses, whether those models are as effective as one might always imagine in circumstances. I am not challenging whether it is or not, but I think it is very hard to say whether one model is better than another given the complexity of so many of the financial instruments. It really is a test of those that oversee, from my perspective, anyway, the building of those models, that they have the capacity to make a judgment about whether they are fully impacting all the issues.

Thank you, Mr. Chairman.

Senator BENNETT. Thank you.

Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you.

Gentlemen, welcome. We appreciate your appearance today. As each of you may be aware, some of my colleagues on this Committee and I introduced legislation before the August break that would reform oversight for two of the other GSE's, Fannie and Freddie. And my question to each of you is: Do you think we should explore including the Finance Board in that legislation as well? Secretary Abernathy?

Mr. ABERNATHY. Well, if I could, Senator, Secretary Snow is going to speak directly to that point tomorrow, and I certainly do not want to front-run him, presenting any views. But I will say this: We looked carefully at your legislation as we were evaluating those issues, and so we have taken very much into account your legislation and the reasoning behind it. And I believe that has been an excellent contribution to the debate.

But with regard to whether or not we should include them, I would like to save that for Secretary Snow's statement tomorrow, if I may.

Senator HAGEL. Do you know if the Secretary will address that issue tomorrow in the House?

Mr. ABERNATHY. That is in the whole panoply of things that he is presenting. That is right. We are looking at the GSE's in their totality, the housing GSE's, all of them together.

Senator HAGEL. So you do not want to venture any speculation on whether we should take the Finance Board and include that?

Mr. ABERNATHY. I will be happy to after Secretary Snow does.

[Laughter.]

I will let him make the news.

Senator HAGEL. He is Gramm-trained, you can tell, cannot you, Mr. Chairman?

[Laughter.]

Mr. Korsmo.

Mr. KORSMO. At the risk of being the second duck in this shooting gallery, for a different reason, obviously I think the primary role of any regulator is to ensure the safety and soundness of those institutions it regulates. I think to the extent that we create as

strong as possible regulatory oversight, not just for the 12 GSE's that I oversee but for all 14, I think that is important. Given the fact that I am the Chair of a five-person Board who is reluctant to take a position that has not been adopted by that Board, I guess I would also be reluctant to speculate as to where the best site is for that oversight function to take place. I think it is an important debate. Let me leave it at that. I look forward as well, needless to say, to hearing the Secretary's comments tomorrow.

Senator HAGEL. Spoken like a true Chairman. Thank you.

Well, obviously, we will be talking to Secretary Snow and you, Mr. Secretary, about this, as well as the Federal Home Loan Bank officials, and we would welcome at the appropriate time your input, which I am sure we will receive.

Mr. Chairman, you have developed a very impressive array of additions and completions since you have been Chairman on the Finance Board—objectives, responsibilities—and I think it had redounded, as the Chairman noted and others here today, to more confidence in your organization's oversight, safety, soundness, and credibility. Any additional changes, thoughts, practices, activities, or actions that you are anticipating that you can tell this Committee about to further enhance the effectiveness of the Finance Board?

Mr. KORSMO. Yes, sir. Thank you for asking that question. Obviously, I would hate to make it sound like all it takes is more dollars. We have the luxury as an independent financial regulator that is a nonappropriated agency and can, in essence, adopt its own budget and pass the cost of that budget on to those we regulate.

We are in the process really of a 2-year program to enhance and improve our oversight capacity. It is not something that can change overnight. The difficulty of adding to a staff, frankly, has been an important lesson to us. We had budgeted for this fiscal year to increase our number of examiners, for example, to 24. The reality is we have been unable to hire that many top-quality people and integrate them into our system fast enough.

That having been said, we are continuing that process. We are going to add in this year's budget accountants, some financial analysts who will be assigned specific responsibilities with each of the Banks. I would be remiss if I did not touch quickly on our initiatives in the area of board governance. Board governance has in the last year or so become a watch word, and it has been a focus for the Finance Board as well. We have recently conducted a systemwide audit of board governance at each of the 12 Federal Home Loan Banks. We have an ongoing process to review board governance. We are scheduling a hearing tentatively for October 15, next month, where we will hear from the Banks and from other interested parties about recommended changes, both statutory that we could recommend and regulatory that we could implement that would improve the job that our boards of directors do.

All of those come together, I think, to create a picture. We are not where we want to be, but we are headed in the right direction.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Senator BENNETT. Thank you.

Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman, and, gentlemen, thank you for being here today.

Both of you have alluded to, at least in your testimony, the multidistrict membership banks issue. Mr. Secretary, do you have a position on that issue?

Mr. ABERNATHY. In our view, the question begins with is there authority for the Federal Housing Finance Board to make a determination. In our view, the statute does not leave that issue to the Finance Board to decide. It has really left that issue with Congress. The statute seems pretty clear that a bank has perhaps an either/or choice, but it is still one district.

Senator REED. Would you urge that Congress give the Board that authority?

Mr. ABERNATHY. We have not addressed the question of whether it is wise to do that or not, and I think at some point we need to do that. And, in fact, if Congress wants to take that issue on, we would be glad to take a look at it and perhaps come back with recommendations.

Senator REED. Thank you.

Chairman Korsmo, do you have a position?

Mr. KORSMO. Let me just say that, first of all, no action by the Finance Board in this area is planned, and while I appreciate Secretary Abernathy's plain reading of the statute, sometimes a plain reading is not enough. As a regulator, I think I would be remiss in suggesting that the Federal Home Loan Bank Act does not provide broad authority to the Federal Housing Finance Board to take any action to the extent that it goes to meeting the primary mission, that is, ensuring the safety and soundness of the Banks.

Unfortunately, sometimes when all one does is recite that circumstance and talk about how the financial services industry has changed and the membership in the Bank System has changed, it has taken for support for a particular policy position. I want to make clear here, because I think there may be some question based on comments others have made about my position, I am neither an advocate of nor an opponent of multidistrict membership. The Chairman alluded earlier to there are many unagreed-upon issues in this system. This is certainly one of them. I think you will find disagreement even among the boards—on boards of directors of individual banks as how to best deal with the changing circumstances in the housing finance industry.

It is an issue that, as I say, at this point we have no plans to take action on.

Senator REED. I think we can mark you down as scrupulously noncommittal.

Mr. KORSMO. Thank you. Yes, sir.

Senator REED. Chairman Korsmo, I am concerned about the process that the Finance Board has followed to make some important decisions, specifically the shared funding program operated by the Chicago Home Loan Bank Board. As I understand it, the staff approved under Section 955.2, and this would be for the purchase of interest in whole loans. But as I understand the Section, it only authorizes purchase of whole loans, not interest, or certain types of State and local housing finance agency bonds. Is that correct?

Mr. KORSMO. No, sir. I think a broader reading of the regulation, again, particularly as it exists on the books now, is that the Banks have authority to purchase mortgage assets both in the form of whole loans and——

Senator REED. Interest loans.

Mr. KORSMO. Thank you. I am losing my train of thought here. Interest in loans as well.

Senator REED. Can I just work my way through here? Because my notes indicate that the only reference to interest in whole loans was in the preamble of the regulation.

Mr. KORSMO. That is correct, sir.

Senator REED. Which was a response to a comment made.

Mr. KORSMO. That is correct, sir, but our general counsel and Office of Supervision's reading of that was that the regulation did indeed provide the authority for banks to apply for new business activity—excuse me, permission to engage in this activity.

I think that it would be good to understand the process, however.

Senator REED. May I make one other point?

Mr. KORSMO. Yes, sir.

Senator REED. Apparently, in July of this year, the Finance Board put this issue out for comment. Is that correct?

Mr. KORSMO. Yes, we put out a draft of a revised AMA reg, yes, sir, for comment.

Senator REED. So why would you ask for comment after the approval of the program, which you say——

Mr. KORSMO. The comment was not on this particular item, although broadly speaking, of course, commenters on this particular proposal, the revision of the entire AMA reg, certainly could have commented on this particular provision. But it was the provision as a whole that was being put forward for comment.

Let me just mention that at our meeting tomorrow, because of the confusion that has developed over what exactly our proposal was and what it entailed, when it was unanimously adopted by the Board on June 18 at our regular meeting, we have—in consultation with my colleagues—all agreed that we will withdraw the proposed regulation, revise it to perhaps clarify what our intentions were in the regard not just of the item that you have mentioned, but some other areas that have been misunderstood as to intention, and reissue—assuming Finance Board adoption of a reissued proposed draft—that for comment.

Senator REED. Well, thank you, Mr. Chairman. I think this raises a very specific issue, but a more general issue of the process of approving and interpretation of your own regulations and public comments on proposed changes. We hope you would act on those general issues.

Mr. KORSMO. Yes, sir, I recognize your concern in this area, and we will take it into consideration.

Senator BENNETT. Thank you very much.

If Secretary Abernathy is right and the law is clear, the law is clear. So, I think you better, if you are going to argue with that, have the firm legal position rather than a general statement that, well, we have the right to do whatever is best for the System. Just an editorial comment as I listen to this back and forth.

COMMENTS OF SENATOR JIM BUNNING

Senator BUNNING. Mr. Chairman, I would like to put in opening remarks.

Senator BENNETT. Without objection, it will appear in the record.

Senator BUNNING. Secretary Abernathy, does the Treasury believe that all GSE's, including the TVA, should register with the SEC?

Mr. ABERNATHY. I would have to say, Senator, when we made the statement with regard to all GSE's, it was a general blanket statement. We did not limit it. With regard to the TVA itself, that is not one type of entity that I have been looking very closely at with regard to——

Senator BUNNING. To GSE, though?

Mr. ABERNATHY. Senator, our view is that entities that are putting significant capital into the markets should be providing the full set of disclosures that other capital participants are required to follow.

Senator BUNNING. Would $30 billion be a——

Mr. ABERNATHY. That is significant to me.

Senator BUNNING. It is significant, okay. I just want to make sure that is the Treasury's position, then; that all GSE's should——

Mr. ABERNATHY. That is our position, yes.

Senator BUNNING. Thank you very much.

Do you believe all—this is for either—housing GSE's should have the same regulator?

Secretary Abernathy.

Mr. ABERNATHY. If I could take a pass on that, Senator, and the reason why is tomorrow Secretary Snow is going to be addressing that very issue, and I would prefer to let him address it first.

Senator BUNNING. And obviously you will take the same pass.

Mr. KORSMO. As a sitting regulator, I will take the same pass, please.

Senator BUNNING. I just had a very good meeting with the Federal Home Loan Bank Board of Cincinnati. They have agreed to voluntarily register alternative of their securities with the SEC. Some of the other banks I just was surprised that in your statement you said San Francisco seems to be now more cooperative in registering.

Mr. ABERNATHY. They certainly seem to be laying the predicate for doing so, but they have not yet made that same commitment that the Cincinnati Bank has. And I certainly would like to praise the Cincinnati Board for making that determination.

Senator BUNNING. Does that trouble you, though, that just 1 out of 12 would come forward and voluntarily register?

Mr. ABERNATHY. I remain troubled until we have all of them registered, frankly, because we do not have the information about those entities that we need to have otherwise.

Mr. KORSMO. Senator, in fairness to some of the other Banks, there has been a varying degree of participation. In fact, all 12 of the Banks have been actively engaged in the process of discussing this issue. There was a meeting yesterday, I believe, of the committee representing 10 Banks, but representing specifically the New York, the San Francisco, and the Pittsburgh bank with SEC

officials. I know the Chicago Bank is also going through the process of preparing some draft documents for the SEC to look at.

While certainly the Cincinnati Bank deserves being singled out for particular praise in their willingness to move ahead in this project, I would be reluctant to characterize the involvement of any of the Banks as being dilatory. They have all, to one degree or another, have recognized their responsibility to provide enhanced disclosures to the marketplace. At this point, we are debating what form that is going to take.

Senator BUNNING. Well, you both realize that registration with the SEC was the red flag for Freddie. When they were trying to get prepared to register with the SEC is when the big red flag went up for them. I hope that is not the case in any Federal Home Loan Bank Board or any area of the country, but to register with the SEC you have to undergo certain registration scrutinies, and I want to make sure, if somebody is reluctant because of that, you should know that as the chief regulator.

Mr. KORSMO. That is correct, sir, and my sincere hope is that the reluctance is based on principle and not on any reluctance that some action or practice would be revealed which would embarrass the Banks. I can assure you that the job we are doing as the safety and soundness overseer and supervisor is sufficient to assure that that is not the case.

Senator BUNNING. Last, but not least, I disagree with your definition of "or."

[Laughter.]

I have more than one child, and I would make comparisons equally as distinguishing as you did in either/or or and/or, and I would be with the Chairman on that regulation. Thank God I am not a lawyer. I do not get confused with the facts, you know.

[Laughter.]

But I believe "or" means exactly what it says. Thank you.

Senator BENNETT. Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, thank you. I have a statement I would like to have put in the record.

Senator BENNETT. Without objection, it will be placed in the record.

Senator ALLARD. I have a question for Mr. Abernathy. In your testimony, you noted that investors in GSE securities should have access to the same corporate disclosures as they have for other companies who publicly offer their securities for investment. In your opinion, how do the current disclosures compare?

Mr. ABERNATHY. The most significant thing that I think that we obtain by having the Federal Home Loan Banks register with the SEC, even if they did not disclose an additional piece of information that they are currently not disclosing is the timing, by registering with the SEC, that the timing of disclosures will be the same to provide comparability for investors, the standards for disclosure and the standards for review of those disclosures will become the same, and it is a high standard, and those who are doing those particular reviews will be the same.

The penalties for false filings would become the same, and it is that high standard that I think has elicited the point that Senator Bunning mentioned. Before Freddie Mac agreed, and they did agree to register the SEC, they were, for a time, saying there would be nothing new that would be disclosed if we agreed to this regime. Then, they agreed to it and discovered maybe it does mean a higher standard. Maybe it does mean that what we are required to comply with is more meaningful. We think that would probably be similar with regard to the Federal Home Loan Banks, not that there is anything hidden, but that it provides a more rigorous standard of comparability, particularly.

Senator ALLARD. Chairman Korsmo, you mentioned in your testimony, the Federal Housing Finance Board is a nonappropriated agency and enacts its own budget and assesses the Banks for the cost of its operation. How important is this authority in your ability to carry out your mission?

Mr. KORSMO. It is extremely important. I think I am still too early in my tenure, frankly, and not having served in a situation where that was not the case, it is hard for me to make a comparison. But I think the fact that we can structure a budget responsibly that provides us the resources we believe we need to carry out our responsibilities is significant. Again, given the fact I have never operated under a different system makes it difficult for me to compare, but I will say that it certainly makes our job easier.

Senator ALLARD. Now, that I have given you both softball questions, I would like to hear the pros and cons from each one of you about this proposal to have a consolidated approach to regulation. One regulator for all financial institutions. I would like to hear your pros, and I would like to hear your cons.

Mr. ABERNATHY. Well, if I could take a pass, Senator. Secretary Snow is, I understand this is an important issue, and I am uncomfortable and have not been able to lay it out for you like I would like to lay the issues before you, but at the risk that if I presented the pros and cons, I am not very good at hiding where I think the weight of the good opinion rests. Rather than laying out the pros and cons and disclosing where I think we are, I will leave that for Secretary Snow, if I might.

Senator ALLARD. Well, then, let me put it this way—you both have the same response about the mission of safety and soundness; would you talk a little about that?

Mr. ABERNATHY. I think the mission of safety and soundness needs to be understood in a large context, and that is not just with regard to the safety and soundness of an institution itself, but also with regard to the markets in which it operates, and that is an important responsibility for the regulators. That is the way our bank regulators operate, and I think that is the way our GSE regulators should operate.

They are looking at the safety and soundness, not just of the institutions, but of the financial system that those institutions are participants in. That is obviously the most important function the regulator has.

Senator ALLARD. I think the farm loans or the home loan, at Farmer Mac, as well as the Fannie Mae and Freddie Mac have all had in the past, at some time or another, some problems with bad

debt. Do you think it is the appropriate role of Government to come in and bail them out when they have debt problems like that or is it that you do not have any choice? Are we absolutely required to?

Mr. ABERNATHY. I do not think that we are required to. I think that we have tried to make it very clear, and——

Senator ALLARD. Well, let me put it this way. Does the "too big to fail" principle come in line, and we simply have to bail them out in order to sustain the economy?

Mr. ABERNATHY. Yes. I think, on many occasions, we have tried to emphasize the fact that there is no Federal guarantee standing behind any of the obligations of the Government Sponsored Enterprises. And those who invest in their debt or in their stocks, where they are publicly traded stocks, they have to evaluate just what is the risk involved with those securities and should not take into account thoughts that there is some Federal guarantee.

Now, what would happen if one of those institutions was on the point of failure? Frankly, we have good regulators, hopefully, to prevent that from happening, to make sure that there is adequate levels of capital maintained by each of these institutions and that the——

Senator ALLARD. How do we make sure that happens?

Mr. ABERNATHY. The best way to do that, I think, is by a system of ongoing, on-site examination. We have a lot of enthusiasm for the steps that Chairman Korsmo has brought to pass on the Federal Housing Finance Board to beef up that examination pool.

Senator ALLARD. Does that mean bringing all of the regulators into one, uniform approach?

[Laughter.]

Mr. ABERNATHY. Well, I will let Secretary Snow give his views on that, if I may.

Senator ALLARD. Mr. Korsmo, would you respond to that.

Mr. KORSMO. Obviously, Secretary Abernathy has a larger responsibility, and my context is to focus on the Federal Home Loan Bank System, and I have ducked the question as effectively, as Secretary Bunning will tell you, perhaps not as effectively, but I have made the effort.

Let me say one thing, however, I think there is a——

Senator BENNETT. At least as often.

Mr. KORSMO. At least as often. Thank you, Mr. Chairman.

[Laughter.]

Let me say one thing, in terms of a pro and con, I think the argument in favor of a single regulator will be how will the larger market look at the particular Government Sponsored Enterprise who is not subject to the same regulatory oversight in terms of site, as opposed to quality that is not included in that process.

The flip side of that, of course, is the familiarity that a particular regulator can develop with the policies, practices, and institutions over which that regulator has responsibility is certainly easier if it is focused on a particular entity. I think there is some concern, and I do not mean to speculate on this part, but I think there is some concern among the Federal Home Loan Banks what would happen to us if we were buried, if you will, with Fannie Mae and Freddie Mac.

And I think that is perhaps a legitimate concern, but I too will wait for Secretary Snow's view tomorrow.

Senator ALLARD. Mr. Chairman, I was going to yield some time for my colleague, the Senator from Kentucky, but I see my time has expired.

Senator BENNETT. Senator Miller has joined us, so we will go to Senator Miller and then come back to Senator Bunning.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. I do not think I want to just get here and start to speak. Let me listen for a while, Mr. Chairman.

Senator BENNETT. Okay.

Senator BUNNING. I just have one question, Mr. Chairman.

Senator BENNETT. Sure. Senator Bunning.

Senator BUNNING. Secretary Abernathy, you made the statement about oversight and watching closely those entities, GSE's particularly. I am going to bring the TVA back to you. They are unregulated by anyone. No one, except these three commissioners, has anything to say about TVA. They sell up to $30 billion worth of debt. It is AAA because everybody else thinks that it is backed by the full faith and credit of the U.S. Government.

FERC, who oversees almost every other entity in electric generation, has not one thing to say about the TVA. I suggest that the Treasury makes very sure that if you are going to include people in oversight and regulation that you look at a GSE called the TVA, which is unregulated and governed by three people.

Senator ALLARD. That is a powerful argument, Senator. Thank you. We will look at it.

Senator BENNETT. Thank you, both.

Secretary Abernathy, you made note in your comments that Freddie Mac has so far failed to register, in spite of the fact that they promised.

Senator ALLARD. And I will say, if I could, Mr. Chairman, we have no doubt about Freddie Mac's willingness and intention to comply. We are eager to see it happen as soon as possible, but we have no doubts that they will comply.

Senator BENNETT. Very good.

Thank you, both. We appreciate your testimony here today, and we appreciate your service to the Nation in the various positions that you hold.

Mr. ABERNATHY. Thank you, Mr. Chairman.

Senator BENNETT. We will look forward, with great interest, to Secretary Snow's answers to the questions you have so artfully dodged here today.

[Laughter.]

Mr. ABERNATHY. Thank you, Mr. Chairman.

Mr. KORSMO. Thank you, Mr. Chairman.

Senator BENNETT. We now move to our second panel.

We are going to hear from them in this order, regardless of where their name tags go. We will hear first from Norman B. Rice, who is the President and CEO of the Federal Home Loan Bank of Seattle; Mike Middleton, the President and CEO of the Community Bank of Tri-County, Waldorf, Maryland. Senator Sarbanes had hoped to be here, Mr. Middleton, to introduce you to the Com-

mittee, and he may yet appear. If he does, we will take appropriate notice of that.

Sheila Bair, who is the Dean's Professor of Financial Regulatory Policy at the Isenberg School of Management at the University of Massachusetts. Sheila is well known to this Committee and its Members and staff; Terry Smith, President of the Federal Home Loan Bank of Dallas; and David Hemingway, Executive Vice President of Zions First National Bank in Salt Lake City, Utah.

I must exercise the hometown prerogative of introducing Mr. Hemingway to the Committee. He has been a witness before the Committee before on other issues and is very knowledgeable. I do recall a conversation with one of my colleagues in the House about an issue where Zions Bank was involved, and the House Member said to me, "Now, let us see, was that Roger Zion that owns that bank?"

And I said, "No, it was Brigham Young that started that bank." [Laughter.]

And Zion has a reference to something other than a family. With that, we welcome you all, and, Mr. Rice, we will start with you.

STATEMENT OF NORMAN B. RICE
PRESIDENT AND CHIEF EXECUTIVE OFFICER
FEDERAL HOME LOAN BANK OF SEATTLE

Mr. RICE. Good afternoon, Mr. Chairman and Members of the Subcommittee. I am Norman B. Rice, President and Chief Executive Officer of the Federal Home Loan Bank of Seattle, and I would like to thank Chairman Bennett and the Subcommittee for the opportunity to provide my perspective on the critical role the Federal Home Loan Banks play in building strong communities and healthy economies across America.

The 12 Federal Home Loan Banks have a long history of service and accountability to the more than 8,000 financial institutions we serve, to the millions of individuals and families we help realize the American Dream of homeownership, and to the regulators and Congress who oversee our system.

It is not the history of our Banks that I want to talk about this afternoon. Where we have been and what we have accomplished as a Bank System is significant and well documented. My focus is on the relevance of the Bank System today—and in the future—and the essential role we play on behalf of our financial institution members, and the economic health of our country.

I will start with what I consider to be the most important element of the Federal Home Loan Banks. We are a cooperative. Our members own the Bank System, and we are accountable to them. These are the Banks, credit unions, thrifts, and other institutions that give our communities critically needed access to credit. These are the risk-takers whose leadership and resources build stronger towns, cities and, to a very real extent, a stronger Nation.

They are able to do that as part of a cooperative that provides each member, small and large, the same access to a stable, low-cost, and reliable source of wholesale funding. No other housing GSE or financial institution can replicate our System's unique partnerships of bank, member, and community.

As I sit here before you today, the Federal Home Loan Banks and the housing GSE's are facing significant challenges and changes regarding their business practices, regulatory structure, and mission-based programs and activities. In the weeks and months ahead, as this Subcommittee and other Members of Congress debate the future of the Federal Home Loan Banks and the housing GSE's, I would like to offer some questions and principles for you to consider in your discussion, as well as clear evidence of the powerful impact our bank system has on the economic health of our country.

Over the course of any week, I am asked by a number of people what the Federal Home Loan Bank of Seattle is and what it does. And my short answer is this: We help ensure that Americans have homes and a stable local economy. That is a good quick response for anyone unfamiliar with the Home Loan Banks, but for the purpose of our discussion today, I would like to offer a more comprehensive—and slightly different—way to look at the value and the benefits provided by the Bank System.

Imagine, if you will, our country with the 12 Home Loan Banks and then consider the following: The Bank System extends nearly a half-trillion dollars in advances, what we call loans, to our member financial institutions annually, strengthening those local economies, and homeownership. Imagine those dollars gone.

Since 1991, the Federal Home Loan Banks have awarded $1.6 billion in Affordable Housing Programs grants, helping to create 360,000 low-income housing units across the country. Imagine those homes gone.

Since 1990, the Bank System has provided nearly $36 billion in reduced-rate, long-term loans for low-income housing and economic development. Imagine those dollars, and homes, and businesses gone.

Now, imagine the collective impact on our national economy. I would urge you to ask yourselves how would your local banks compete if they did not have access to the capital markets? Where would your constituents go to get loans to buy homes and run their businesses? Now, go one step further. If the housing GSE's did not exist today, what would you put in their place? I believe you would come back to something that looked a lot like the Federal Home Loan Bank System as it is, and here is why.

The Bank System is funded entirely through private capital. The cooperative is built by private owners who have put more than $36 billion of their own money at risk to capitalize the system. The Bank System is cooperatively owned to support, rather than compete, with the private marketplace. Our stock is not publicly traded, and we do not have third-party investors pulling out value. The Bank System is organized by region, ensuring that each Bank is connected and responsive to local markets.

The Bank System pays its fair share of taxes. The Home Loan Banks carry a special tax burden that cannot be sheltered and is equivalent to a Federal corporate tax rate. The Bank System has been required, since 1989, to pay off the REFCORP debt and provide 10 percent of its net income in support of low-income housing. This is the single largest private source of housing subsidy in the United States.

The Bank System is a critical source of liquidity through all parts of the economic cycle. So this country's network of community banks relies on our capacity to access the capital markets on their behalf.

The Bank System has the capacity to innovate and keep pace with an evolving financial services industry. This is why we offer mortgage purchase programs. Our members have told us they can better serve homebuyers and local markets if there is more competition in the secondary mortgage market. It is no accident that our program volume has accelerated from zero to almost $100 billion.

As you can see, it is not a difficult task to illustrate the benefits provided by the Home Loan Banks. Today, as one of the 12 Presidents within the System, I stand committed to work with you to further the mission and the vision of our Bank System and meet the evolving needs and issues facing our housing GSE's.

On the matter of consolidation of GSE regulators, whether or not Congress determines that a single regulator is the appropriate direction or not, all three housing GSE's must have strong, consistent regulatory oversight to ensure both safety and soundness and mission achievement. There can be no debate on this point.

And that means it is time to straighten out the wide variety of requirements and oversight regarding the housing GSE's. For example, why did two housing GSE's have lower capital requirements than the 12 Home Loan Banks which carry less credit risk? Why is there inconsistent mission oversight, with the Home Loan Banks delivering cash grants, while the other housing GSE's hit a different set of affordable housing goals?

What public policy goal is advanced when roadblocks are put in front of our Bank System, when we respond to our members' stated desire to have greater competition in the secondary mortgage market, and when, in fact, those roadblocks actually hinder our ability to drive more funding to our member financial institutions and their communities? I have heard it called "mission creep," but from my point of view, it is more like "mission leap." When our mortgage purchase programs are allowed to grow, they allow us to take significant steps toward fulfilling our mission and not walking away from it.

I want to be clear today that I believe the onus for strengthening our system lies not only with Congress and regulators, but also with the Home Loan Banks themselves. We need to continue to step up and accept the risk in our System and our industry and embrace the fact that more intense public oversight is inevitable. We welcome that public oversight because, if done smartly, it will strengthen our Bank System, ultimately, and the economy of this country.

In closing, I would like to leave you with five principles that I believe should inform your discussions and decisions in the months to come:

One, private capital is the most effective cushion to guard the public against the risks inherent in our enterprises. As a cooperative, the Home Loan Banks are capitalized by their customers who monitor risk-taking in a way that third-party shareholders cannot.

Two, insist on competition among housing GSE's, rather than competition with the private financial services industry.

Three, demand that more of the value created by the housing GSE's be delivered to the housing finance system and consumers, rather than private investors.

Four, demand consistent strong and smart regulatory oversight for all housing GSE's and recognize the critical differences between the Bank System and publicly traded housing GSE's.

And last, but not least, demand an intense focus on our mission, hold us accountable, and keep in mind what America would look like if the Federal Home Loan Banks did not exist.

That concludes my remarks, and I thank you, again, for allowing me to testify today, and I will be happy to answer questions at the appropriate time.

Senator BENNETT. Thank you very much. We appreciate that.

Mr. Middleton.

STATEMENT OF MICHAEL MIDDLETON
VICE-CHAIRMAN, FEDERAL HOME LOAN BANK OF ATLANTA
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
COMMUNITY BANK OF TRI-COUNTY, WALDORF, MARYLAND

Mr. MIDDLETON. Good afternoon, Chairman Bennett, Senator Bunning, Senator Miller and, hopefully soon, Senator Sarbanes.

[Laughter.]

Thank you for the opportunity to discuss something that——

Senator BENNETT. You are among friends, even if he is not here.

[Laughter.]

Mr. MIDDLETON. He is a good friend.

Thank you for the opportunity to discuss something that is very important to my business and my community, which is the Federal Home Loan Bank System. I am Michael Middleton, Chairman and CEO of the Community Bank of Tri-County, which is a $300-million community bank located in Waldorf, Maryland.

I serve as Maryland's elected Director to the Federal Home Loan Bank of Atlanta's Board, and I am honored to serve as Vice Chairman on that Board. I am also a Member of the Board of the Council of the Federal Home Loan Banks.

I am testifying today on behalf of the Federal Home Loan Bank of Atlanta. Mr. Chairman, while I have covered details in my written testimony, I would just like to highlight some of the more important issues.

As a member and a long-time user of the Federal Home Loan Bank advances, as well as other products, as well as a Director to the Atlanta Bank, I have gained a broad perspective on the system, and I hope it will be of use to the Subcommittee.

The Community Bank of Tri-County serves southern Maryland. Our customer base draws from a broad economic range. We tailor our services and our products to meet the needs of our communities, while competing with larger regional and national financial institutions.

At my bank, we take our CRA responsibilities very seriously. Many community banks, are faced with the challenges of meeting their CRA requirements. And the Federal Home Loan Banks provide us with the tools and the skills to meet those challenges.

The Federal Home Loan Bank System helps level the competitive playing field in many, many ways. As GSE's, the 12 Federal Home Loan Banks were created to stabilize and improve the availability of funds to support homeownership. Today, capitalized by the cooperative stock of its member owners, the Banks still fulfill that mission. The Banks and their members are the largest source of residential and community development credit in the United States.

Through the work of many on this Committee, including Senators Hagel, Johnson, and Bayh, to modernize the Federal Home Loan Bank System in the Gramm-Leach-Bliley Act, it helped direct and expand the reach of the Banks and their members by providing critical residential community development credit to rural and urban communities.

I believe it is important to note that the Federal Home Loan Bank is the only institution in the United States that fulfills this mission. The Banks are a stable, low-cost, reliable source of short- and long-term funding. For the many small and medium-sized community banks, the Federal Home Loan Banks are essential because direct borrowing from the capital markets is not a viable option for us.

The Bank System enables us to remain independent and to continue to be an economic engine in our communities. That, of course, translates into jobs.

The Federal Home Loan Banks developed their programs in response to their members. For example, in response to member demand, the Atlanta Bank now offers both the MPP and the MPF Acquired Member Assets Program. The Bank's members that use these programs are pleased that they have yet another financial tool in delivering competitive credit products.

Like the advance programs, the AMA programs, again, help level the competitive playing field for community banks. At my bank, Community Bank of Tri-County, we rely on Atlanta's programs to deliver financial service to our communities. Like many other areas, our communities need more affordable housing, improved medical school, and volunteer and rescue support facilities. The Federal Home Loan Bank is often an invisible, but vital, partner fulfilling these needs.

Community Bank has partnered with nonprofit CDC's in using the Federal Home Loan Bank programs to create layered funding that supports affordable housing and infrastructure development. We do this with programs, like the AHP, or the Atlanta Bank's EDGE program. These, and similar Federal Home Loan Bank programs, make affordable housing and community development projects economically feasible in communities such as mine.

A good example of this is the Yardley Hills project in Calvert County, Maryland. I am sure Senator Sarbanes is familiar with that section of Maryland. That project, as an example, used $2.7 million in complex, layered funding through our partnership with the Atlanta Bank's AHP.

In another project, we used the EDGE program to provide the Jarboe Family Head Start Center in St. Mary's County with permanent funding, when other traditional banking sources of larger regional banks became unavailable.

The Federal Home Loan Banks also helped their members provide other needed forms of community development credit. Community Financial Institutions, CFI's, may now pledge, as collateral for advances, small business, small farm, and small agribusiness loans. This may allow smaller institutions, particularly in rural areas, to better serve the community development credit needs of their neighborhoods and their farmers.

I strongly believe that the Federal Home Loan Bank System is able to provide these important benefits because of its dynamic membership of both large and small institutions and its regional, decentralized, and cooperative structure. I can say, unequivocally, that without the Federal Home Loan Banks and the programs they provide, it would be far more difficult for my bank, and the thousands of other community banks, to remain independent, competitive, and capable of extending important housing and community development credits.

I have given you examples of why the Federal Home Loan Bank System is so vital for community banks like mine, but I am also a Member of the Board of Directors of the Federal Home Loan Bank in Atlanta, and that imposes additional important responsibilities.

The Atlanta Bank and its Board support the Administration's position that housing GSE's should provide complete and transparent financial disclosures that constitute the best of class. That is why we, along with other Federal Home Loan Banks, have been working with all relevant parties to resolve the specific issues presented by the Federal Home Loan Bank statutory mission, cooperative structure, and joint several liability.

In fact, the Atlanta Bank will file its annual financial reports for 2003 in SEC 10–K format.

Senator BENNETT. Could you summarize?

Mr. MIDDLETON. Thank you.

I will tell you what. This is the summary.

Senator BENNETT. All right.

Mr. MIDDLETON. I am sorry if I have taken too much time of the Committee.

As a director, I want the Atlanta Bank to meet the highest standards of disclosure. At the same time, and this is an important distinction, as a director, I have an obligation to the member owners of the FHLB to be certain that the disclosures are administered in a manner that would not impair the mission or the operation of the Bank or increase its cost of funds.

Again, as a director, if I vote to voluntarily register the Atlanta Bank's equity with the SEC, not only do I assume additional personal, civil, and criminal liabilities for the relevant statutes, but I also assume a liability to our members for my decision to voluntary register.

Thus, it is most compelling that the critical issues have been satisfactorily resolved and sustainable written agreements reached. Reasonably known issues, critical accounting issues, must be resolved in a way that all Federal Home Loan Banks and their members can rely on going forward without the threat of quarter-to-quarter, year-to-year reconsideration with each SEC filing.

And there I will abbreviate my text. Thank you, Senator.

Senator BENNETT. Thank you very much.

Mr. MIDDLETON. It has been a great opportunity.

Senator BENNETT. Yes. We will be happy to put the entire statement in the record.

Mr. MIDDLETON. Thank you.

Senator BENNETT. Ms. Bair, again, welcome to the Committee, where you are well-known and spent a good portion of your career working on both sides of the aisle.

STATEMENT OF SHEILA C. BAIR
DEAN'S PROFESSOR OF FINANCIAL REGULATORY POLICY
ISENBERG SCHOOL OF MANAGEMENT
UNIVERSITY OF MASSACHUSETTS

Ms. BAIR. Thank you, Mr. Chairman. It is good to be back. Senator Bunning and Miller, thank you for being here.

It is a pleasure to appear before you today to assist you in your oversight of the Federal Home Loan Bank System. It is in the spirit of System supporter that I come to you this morning to raise two issues that I believe warrant your attention: Multidistrict membership and expansion of the System's mortgage acquisition programs.

These issue are important because their resolution will help determine the future of the System and its long-term stability. They are examined in detail in a paper I recently completed that was funded by a grant to the School of Management from the Fannie Mae Corporation, which I would like to submit for the record.

Senator BENNETT. Without objection, it will be put in the record.

Ms. BAIR. Thank you.

Ms. BAIR. Thank you. The conclusions reached in the paper are my own and do not reflect the views of the research sponsor.

After summarizing my paper, I will make some general observations about the FHLB systems regulatory structure in relation to efforts underway to improve safety and soundness regulation of Fannie Mae and Freddie Mac.

Recent industry consolidations have prompted some to call for allowing members to belong to more than one district Federal Home Loan Bank.

My primary objection to multidistrict membership is that Congress, not the FHFB, should decide whether such a fundamental change should be made to the System's historic regional and cooperative nature. I am also concerned that multidistrict membership could have a destabilizing influence on the System. Multidistrict membership would allow large institutions to "shop" their advance activity among multiple FHLBanks, but because all of the FHLBanks raise funds in the same way, their ability to compete, based on price, will be limited. As a consequence, they will likely compete on collateral and credit standards. Allowing one member to have multiple relationships with FHLBanks would also increase operational risk, since the System lacks safeguards to obviate the multiple pledging of collateral or the prospect of competing blanket liens. Moreover, allowing multiple memberships could increase large borrow activity in the System as a whole, thus, exacerbating large borrower concentrations. Nearly 24 percent of all advance activity is already concentrated in the System's 10 top borrowers.

Multidistrict membership would, by definition, help only institutions large enough to take advantage of it, and fundamentally alter the basic concept of the System—a cooperative of regional banks existing to serve the funding needs of institutions headquartered in their districts. Moreover, given the seismic consolidation activity that occurred in the 1980's, which the System weathered quite well, it is difficult to see why current consolidation activity should provide the impetus for such a dramatic restructuring.

The System's mortgage acquisition programs also primarily benefits the System's largest members. Begun in 1997 as a small pilot capped at $750 million, these programs have grown exponentially. The System now holds $90 billion worth of mortgages in portfolio, representing over 10 percent of its assets.

There is nothing in the System's legislative history or authorizing statute that grants authority for direct mortgage purchases, and the other two major housing GSE's—Fannie Mae and Freddie Mac—were established and chartered by Congress expressly for that purpose. Congress, not the individual FHLBanks or the FHFB, should decide whether it wants the System to be a major player in the secondary mortgage market, and if so, the terms and limitations that should apply.

The risk associated with mortgage acquisition are distinctly different from those associated with the System's traditional role of making fully collateralized advances. Advances have prepayment penalties and call features that allow the FHLBanks to effectively manage their interest rate risks. Different, more complex, tools are needed for the interest rate/prepayment risk presented by mortgages held in portfolio. Operational risk is also significant. There is a serious question as to whether the System has sufficient numbers of qualified staff or infrastructure needed to manage even the day-to-day risk associated with secondary mortgage market participation. Regarding credit risk, the mortgage acquisition program's proponents boast that the originators, not the FHLBanks, retain the credit risk. In truth, the originators provide credit enhancements that are only as good as the FHLBanks require them to be based on their own interpretation of historical default data, which again is outside the traditional mission and expertise. It is telling that a recent FHFB proposed rulemaking, now withdrawn, would have eliminated one of the program's most important tools in managing credit risk; the requirement that pools of purchased mortgage assets, achieve an investment grade rating from an independent rating agency.

No adequate public policy basis has been advanced for the System's foray into this new, riskier line of business. Though promotional materials for the programs claim that they are designed to help smaller institutions, available data suggests that they are being run overwhelmingly for the benefit of large originators. According to trade journal reports, the top five mortgage originators sold $42.7 billion in mortgages to the FHLBanks in 2002. Assuming the accuracy of this report, these five institutions would account for almost all of the $45.7 billion in FHLBank mortgage acquisitions in 2002.

Questions about the capability of the System to manage new risks associated with multidistrict membership and mortgage ac-

quisition programs are heightened by longstanding weaknesses in the FHFB examination process, identified by the GAO in 1998 and again in 2002. Though the FHFB has taken a number of steps to address these weaknesses, including increasing the number of examiners and putting greater focus on major risk and the quality of controls at FHLBanks, the GAO found, in a report released last February, that it is still too soon to evaluate the effectiveness of these measures. We heard from Chairman Korsmo earlier that they are now up to 17 examiners, with plans to increase that total to 24 by 2004, and I believe he said 30 by the end of 2005. However, according to its fiscal year 2003 budget, only $9.7 million of its $27 million budget was allocated for the Office of Supervision. By way of comparison, Treasury's two bank regulatory bureaus, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, were typically assigned teams of 20 to 30 examiners to each of its large institutions, and will spend 70 to 80 percent of their budgets in direct support of supervision.

More fundamentally, the structure of the FHFB suffers from many of the same defects now being scrutinized at the Office of Federal Housing Enterprise Oversight. It is a small, low-profile agency that simply cannot attract and retain the quality of staff that it needs. It exists outside the financial regulatory mainstream and, thus does not benefit from the routine, day-to-day interaction that occurs among the major bank regulatory agencies. It is responsible for only 12 banks, plus the Office of Finance, and narrow constituent base that creates the perception of "captive regulator." Other major financial regulators have a much broader regulatory base, and their actions are generally reflective of the views and interests of diverse and competing constituencies. When a regulator's jurisdiction is confined to a small group of closely aligned institutions, the pressure and input it receives can become narrowly focused and one-sided. It becomes difficult for that regulator to stay objective and "above the fray."

Should a new agency be created at the Treasury Department for oversight of Fannie Mae and Freddie Mac, I believe it would be a stronger agency if it also included oversight of the FHLB System. The new regulator would have a bigger, better view of the housing finance market and would be in a better position to evaluate the advantages and dangers of the major housing GSE's competing directly with each other in the same lines of business. From the standpoint of systemic risk and taxpayer exposure, it is just as important to the Government for the FHLB System to have quality safety and soundness oversight, as it is for Fannie and Freddie. At year-end 2002, the System had $668 billion in outstanding debt, compared to Fannie's $884 billion and Freddie's $644 billion. It enjoys the same implied Government guarantee, with an even more generous line of credit from the U.S. Treasury.

The competitive impact on FHLB funding costs should also be weighed in the balance when considering whether to merge the FHFB into the new agency. The creation of a credible, high-quality GSE regulator within the Treasury will likely receive a positive reaction in the capital markets, which could reduce Fannie and Freddie's funding costs. If the FHLB System is left out, that could widen spreads between FHLBank securities and those issued by

the enterprises. Wider spreads would in turn mean the higher cost of funds for the FHLBanks, which would adversely impact the price of advances and ultimately raise costs for homeowners.

Strong momentum is building with the creation of a credible, high-quality regulator within the Treasury Department to replace OFHEO. Now would be a propitious time for the Congress to consider whether oversight of the FHLB System should also be placed under this new regulator. To be sure, there are important policy determinations that Congress needs to make regarding the FHLB System's mission and future, and it is important not to impede the momentum behind the transfer of OFHEO's safety and soundness functions. However, concurrent action could assure quality regulation of all three major housing GSE's and prevent a widening of spreads which could further weaken the System.

Thank you, Mr. Chairman.

Senator BENNETT. Thank you very much.

Mr. Smith, we appreciate your being here.

STATEMENT OF TERRY SMITH
PRESIDENT, FEDERAL HOME LOAN BANK OF DALLAS

Mr. SMITH. Mr. Chairman, Senator Sarbanes, Senator Bunning, I appreciate the opportunity to speak to you today about the Federal Home Loan Banks. My name is Terry Smith. I am the President of the Home Loan Bank of Dallas. I am pleased to provide an update on the Bank's activities and our progress implementing the Home Loan Bank provisions of Gramm-Leach-Bliley. My written statement includes an overview of a range of issues related to those banks, and since my colleagues are addressing some of those same issues, I will limit my oral remarks and ask that the remainder of my statement be accepted for the record.

Senator BENNETT. It shall be printed in the record.

Mr. SMITH. Thank you.

I would like to stress four points related to the Federal Home Loan Banks.

First, the Banks are a valuable resource for more than 8,000 member financial institutions, representing 78 percent of all FDIC-insured depository institutions. Those members, primarily community banks and thrifts, use the Banks' advances and housing programs to meet the mortgage and community lending needs of their local markets and use our affordable housing programs to make housing more affordable for thousands of low-income families in those communities. This is our primary purpose, and we are proud of our accomplishments.

Second, the Banks continue to be financially strong and conservatively managed cooperative institutions. The Banks are well capitalized, maintaining capital asset ratios between 4 and 5 percent. The Banks' advances are fully collateralized, allowing the Banks to maintain their enviable record of never having suffered a credit loss on a member advance in their 71-year history.

The Banks also manage interest rate risk very conservatively, using derivatives in a very precise and prudent way to minimize the difference between the maturities of their assets and liabilities. These risk management practices enable each of the Banks individually to maintain a AAA rating and for the Banks collectively to

enjoy the same high ratings on their consolidated obligations, the debt of the 12 banks issued jointly.

Third, the Banks' cooperative corporate structure reinforces our conservative approach to risk management and eliminates many of the incentives that a publicly traded company might have to increase its risk profile in hopes of achieving higher returns for its shareholders. There is no stock compensation for management, directors, or employees of the Banks.

Only members may purchase a Bank's capital stock, which they do in order to obtain access to the Bank's products, and not primarily as a stand-alone investment. The price of a Bank's capital stock does not fluctuate, but can only be purchased or repurchased at its par value.

Members expect stability, reliability and consistency of dividends, and credit product pricing, rather than a high yield. And our boards of directors are structured to ensure that outcome.

No members of management serve on the board of directors. A majority of each bank's directors are elected representatives of member institutions, primarily from community financial institutions, who have a vested interest in the Bank's long-term viability and stability. The remaining directors are public interest directors appointed by the Finance board.

Fourth, the Banks are subject to rigorous safety and soundness oversight and regulation. Finance Board regulations govern every facet of the Bank's operations, from advances pricing to eligible collateral, to risk management, to capital plans, to directors' responsibilities, and so on.

The Finance Board also collects and monitors financial and risk management data from the Banks each month, performing ongoing reviews of various aspects of the Bank's operations and conducts annual on-site examinations of all 12 Home Loan Banks.

When Congress enacted the Gramm-Leach-Bliley Act in 1999, it included several provisions related to the Banks' operations. The new law provided for universal voluntary membership and equal access to the Banks for all types of financial institutions. It established a framework for more permanent capital structure that includes total leverage- and risk-based capital requirements for the Bank for the first time.

It also expanded the types of collateral the community banks can pledge to secure advances which has allowed those institutions to take greater advantage of their access to the Banks and to meet the credit needs of their communities.

These changes have, and will continue to have, a positive impact on the Banks' ongoing ability to fulfill their statutory role and to do so safely and soundly.

I would be happy to answer questions of the Committee at the appropriate time.

Senator BENNETT. Thank you.

Mr. Hemingway.

STATEMENT OF DAVID W. HEMINGWAY
DIRECTOR, FEDERAL HOME LOAN BANK OF SEATTLE
EXECUTIVE VICE PRESIDENT
ZIONS FIRST NATIONAL BANK, SALT LAKE CITY, UTAH

Mr. HEMINGWAY. Thank you. Good afternoon, Chairman Bennett and Senator Sarbanes.

My name is David Hemingway, and I am Executive Vice President of Zions First National Bank, based in Salt Lake City, Utah. I am also a Member of the Board of Directors of the Federal Home Loan Bank of Seattle.

I would like to thank Chairman Bennett and the Subcommittee for the opportunity to speak this afternoon on behalf of the Federal Home Loan Bank System.

First, I would like to discuss why Zions Bank and other regional and community financial institutions across our country use the Home Loan Banks and then address the issue of corporate governance and the responsibility within the Bank System.

In 1932, the Bank System was created to provide liquidity to the savings and loan industry. At that point in history, there was no secondary market for mortgages, and the S&L's needed a way to borrow against the mortgages in their portfolio, so the Federal Home Loan Bank System was created, providing low-cost advances to meet the needs of community financial institutions and their customers.

This need for liquidity in our Nation's network of community banks is as real today as it was in 1932, and the only housing GSE that can meet this need is the Federal Home Loan Bank System. Let me briefly explain how this works.

Banks accept deposits, as you all know, and then make loans with a portion of those deposits. The deposits not invested in loans are invested in securities, such as U.S. Treasury notes.

There is no rule that says, in the real world, that deposits will always be greater than the loans outstanding in a financial institution. These fluctuate from day-to-day. There is also no rule that says depositors cannot withdraw their funds at will simply by writing checks.

So, in the case of Zions First National Bank having the balance in Zions' checking account at the Federal Reserve Bank of San Francisco, where banks have their checking accounts in the Federal Reserve System, having that balance increase or decrease by $200 to $300 million in a day is not unusual. And a bank is trying to manage its checking account the same way as you might be managing your own checking account, and a fluctuation of a couple of hundred million dollars is something to be noticed.

Zions has a $1-billion liquidity line from the Federal Home Loan Bank of Seattle. Now, this line of credit from the Federal Home Loan Bank overdraft protection is secured with mortgages, first mortgages, in Zions First National Bank's loan portfolio of about $1.2 billion. When Zions' depositors withdraw $300 million in a day, and I assure you this does happen on a regular basis, we call up the Federal Home Loan Bank of Seattle and borrow $300 million overnight to replace those deposits until they can be replenished in the normal course of business. Now, no other GSE or financial partner can provide or does provide this type of service.

Another area where the Bank System is unique is in providing liquidity in the form of low-cost and long-term loans to regional and community banks that do not have access, and I think the important part here, is do not have access to the capital markets which most community banks do not have access or even smaller regional banks.

Developers of low-income housing projects need long-term fixed-rate loans. The only source of long-term low-cost liabilities for a community bank is the Bank System advance. I have often said that the Home Loan Banks are the savior of our regional and community banks. The System, with its GSE status, AAA rating, cooperative equity structure, and low overhead is the best, and in many cases, the only source of low-cost long-term liquidity for regional and community banks.

I would respectfully and forcefully request that no changes be made to the basic structure of the Bank System which was created to address a very real problem of liquidity for our country's financial institutions, a problem that the Federal Home Loan Banks continue to solve every day.

I will now address the issue of corporate governance and the responsibility within the Bank System.

As both a community banker, for the better part of three decades, and as an elected board member of the Seattle Bank, the issue of board governance is of paramount importance to the financial institutions and communities we serve, and to me, personally.

As a director, I have been elected by the bankers of Utah to watch over their investment in the Seattle Bank. While I am not alone in that role—I share it with 17 other directors, and the management team of the company—I consider it my job to ensure that the financial management of this $47-billion bank is effective over the long-term, including proper stewardship of our shareholders' capital. That is a staggering responsibility when you consider that the funding provided within the Seattle Bank district fuels housing finance, affordable housing initiatives, and economic development in communities from Pago Pago to Walla Walla, Washington, to Blanding, Utah.

When I was elected to serve as a director, I understood the critical importance of my role and what I needed to bring to the Board; namely, my personal integrity and accountability, my financial services and community banking experience.

We are all aware that a quantum shift has occurred in how American corporations, large and small, privately held or publicly traded, must be run. We share with our regulator the Federal Housing Finance Board, the Treasury, and Congress, the sense of urgency that is so pervasive today regarding the need for increased accountability, and we have worked hard over the last several years to significantly strengthen the leadership and oversight of our Banks.

Over the course of the last year, the Seattle Bank board has created, adopted, and publicly disclosed a set of core principles and guidelines relating to board governance. In addition, we have realigned our board committee structure to more effectively oversee all facets of the Bank's operations, upgraded education and training for all directors, and created a website that provides directors

with faster access to a wide range of information critical to their board roles.

Our regulator, the Federal Housing Finance Board, is also diligent in overseeing and supporting sound corporate governance practices across the Bank System. The Finance Board just recently completed a horizontal review designed to assist the Agency in directing and developing its supervisory and regulatory initiatives. The Finance Board interviewed management and board members and reviewed a wide range of bank documents with respect to the board policies, practices, and decisions.

Key questions asked by the Finance board include:

Does your board audit committee provide sufficient oversight of internal and external auditing functions?

Is the audit function independent, reporting only to the board, and is it supported appropriately by directors?

Does the board ensure that material risks are accurately and consistently assessed by management and reported to the board, in compliance with regulation and prudent practices?

I am pleased to say that Seattle Bank has "yes" answers to each of these questions, but that is today. The board's job is to ensure that we have "yes" answers tomorrow, the next day and next year.

As one of 216 bank directors of the various different Banks, I am proud to be a director of the Federal Home Loan Bank System, and I would not have it any other way.

Mr. Chairman, that concludes my testimony. Thank you.

Senator BENNETT. Thank you very much.

Senator Sarbanes, we welcome you. We, by proxy, introduced Mr. Middleton to the Committee, but I understand you wanted to welcome him, and we are happy to hear from you.

COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, I am sure it has certainly been done adequately by you, but I just wanted to take a moment to say that Mike Middleton is a very distinguished business leader in our State and also a distinguished leader in the community. He, in fact, is the Chairman of the Charles County Economic Development Commission's Board of Directors, and I want to just mention one thing.

He has taken, as a volunteer, an active role in teaching ethical decisionmaking to high school students in Charles County, and we very much appreciate that commitment on his part. Of course, he has been a very successful head of the Community Bank of Tri-County in Waldorf, Vice Chairman of the Board of the Federal Home Loan Bank of Atlanta, and we are very pleased he was able to come and be with us today.

Senator BENNETT. He did you proud with his testimony.

Senator SARBANES. Thank you.

Senator BENNETT. While you have the microphone, do you want to either make an opening statement or ask questions? Go ahead.

Senator SARBANES. I will defer to you.

Senator BENNETT. Thank you.

I thank you all. This has been a very informative expression of how the Home Loan Bank System works.

May I go back to the issues that I outlined in my opening statement and see if any of you have any particularly burning opinion that you want to express on these? The first one, whether or not the Home Loan Bank should register with the SEC, we heard that discussed by the first panel, and some of you have mentioned it in passing, but if you have any additional comment that you need to make there, we would appreciate that.

Whether or not a member institution of the System should be permitted to be a member of more than one regional Home Loan Bank, Ms. Bair has made that very clear, as far as her position. If some of the others want to argue with her or support her, whatever, we would look at that.

At what level should the Home Loan Banks be permitted to participate in the secondary mortgage market? And, again, you have discussed that, but if you want to be more sharply focused on that question.

And then, finally, whether or not we should have a single regulator for all of the housing GSE's. I do not want to recover the question of what kind of a regulator that should be. Some of you have outlined your feelings about a regulator, but just the overall question of whether or not Congress should move in the direction of trying to create a single regulator. Those are the four issues that were driving us behind the calling of the hearing, and along with the general comments that you have made, which I stress, again, have been very educational and very helpful, if someone has a very specific, pointed comment they want to make on any one of those four, now is the time.

Mr. RICE. I would make one quick comment, as it relates to the Mortgage Purchase Program, Mr. Chairman. At the Seattle Bank last year, our Mortgage Purchase Program created about $1.75 million in profit that went directly for our Affordable Housing Programs. And at this point in time, about 42 percent of our mortgage purchase loans are for low- and moderate-income individuals. And just in 2 years, we have made extraordinary gains in making sure that the return from the mortgage purchase program goes back to the members and goes back to affordable housing.

That is one point. And the second point is that our members are desirous of having choice; choice to sell their mortgages, and I think choice is fundamental in their decisionmaking, rather than being limited.

We created a program, in direct response to our members' needs, and we are now organizing and setting ourselves up to run it in a safe and sound manner, to come up with some level or cap I think is difficult. I believe the biggest issue is to make sure we have a regulator who can oversee and make sure that we are managing the program in a safe and sound manner.

Mr. MIDDLETON. May I?

Senator BENNETT. Mr. Middleton, yes.

Mr. MIDDLETON. As a $300-million community bank, for us to lend in more residential lending is just part of the business plan. I can tell you we have been doing this for five decades, and we have been selling to the housing GSE for the last two decades. They have had a zero-loss experience.

Senator BENNETT. Which GSE have you utilized?

Mr. MIDDLETON. Freddie Mac.

Senator BENNETT. I see.

Mr. MIDDLETON. However, due to our volume, we get charged a fairly significant guarantor fee. With the MPP, our credit loss experience is reflected in the pricing, and it will allow us to make a business decision to continue this product line in our community because it becomes more profitable for us. So this is a very important service to a community bank.

Senator BENNETT. So you are saying that if you had the opportunity to have a larger secondary mortgage market than exists currently with your choice of Freddie Mac, specifically, if you could do it through a Home Loan Bank, you would either be able to make more money or charge less to your customer or both?

Mr. MIDDLETON. That is correct, sir.

Senator BENNETT. I see. Any other comment?

Ms. Bair, yes, go ahead.

Ms. BAIR. Just a couple of things. First and foremost, my objection to the Mortgage Acquisition Program is that it has not been authorized by Congress. And I think a lot of people were looking the other way when it started as a small program. A lot of people were assuming that because of the capital structure of the Federal Home Loan Bank System, it could not really grow to sizeable levels. It is, in fact, growing exponentially, primarily the Chicago program. I think Seattle has maybe progressed in a little more responsible fashion.

I also think one of the reasons Chicago has been able to grow so exponentially under the existing capital structure is the shared funding program. And to Senator Reed's question earlier, I think there is a real process issue about the way that shared funding came about. The regulations only refer to purchase of whole loans.

Under shared funding, basically, a member of the Chicago Federal Home Loan Bank securitizes the pool of mortgages, creates two tranches, sells the senior tranche back to the Chicago Bank, so it is not a direct securitization. A member is used to securitize, but then the interest and the mortgages are sold back to Chicago Bank. It can then sell those throughout members of the System. In this way, it has been able to get a lot of assets off of its balance sheet and get around the capital problems it would otherwise have.

There is really no public comment. It is questionable whether the regulations currently allow them to be purchasing interests in whole loans, as opposed to the whole loan itself, to Senator Reed's comment.

I believe there are just some process issues and some significant policy issues that need to be dealt with that really are not. These programs are really growing quite rapidly, and I am just concerned that there is not anybody really in charge taking a close look to make sure it is not undermining safety and soundness. It is just not the System. This thing keeps going. You talk about the high credit quality of the loans.

If this is coming out of the Fannie and Freddie business I assume it is, you know, what type of destabilizing effect would this have on the overall market? Nobody is really looking at that. And I think, again, a single regulator, with all three major housing

GSE's, could get a better handle about whether this is a good thing or a bad thing, in terms of the overall housing market.

I would also add that I think, to the extent there is a good justification for the System being in this business, it is for the community banks, and I wish I saw, in the numbers that I am reading, more marketing and delivery of services to the smaller banks, as opposed to the large originators.

Thank you.

Senator BENNETT. Anyone else?

Mr. Hemingway.

Mr. HEMINGWAY. Yes, Senator. I was going to change and talk about a different subject.

Senator BENNETT. Please, go ahead.

Mr. HEMINGWAY. SEC registration.

Senator BENNETT. Right.

Mr. HEMINGWAY. I would like to speak from my experience as a banker on this area, but also, as you may remember, I am also a member of the board of directors of Farmer Mac. I have some experience in the area of being involved with a GSE, where Zions is a large shareholder, for an entity that is regulated by the SEC. One of the issues that needs to be taken into consideration is the mission of the SEC is quite different than the mission of a safety and soundness regulator, whether it be the Comptroller of the Currency or the Federal Housing Finance Board or, in the case of Farmer Mac, the FCA.

The mission of the SEC is to protect investors, and particularly small investors in public securities. The mission of a safety and soundness regulator is to make sure that the financial institutions that they regulate are safe and sound. So they approach problems differently, and I will give you an example, which raises some of the concerns here.

The example is take loan loss reserves. Anybody that has been in banking very long knows that the regulators love to see large loan loss reserves. They would like to see them as large as possible because that gives protection to the Bank and to the FDIC, ultimately, and the U.S. Government if there are losses in the loan portfolio.

But the SEC takes an exact opposite position. They believe that the loan loss reserves in the various different financial institutions are too large, and they view the large loan loss reserves being a way for financial institutions to manage their earnings. They believe that transparency would require smaller loan reserves. And, of course, they have the accountants, with GAAP, who come out to enforce their views.

You get a board of directors and a management that are being told exactly the opposite from their two regulators, if they, in fact, have two regulators. Their safety and soundness regulator telling them that we believe we would like to see some higher reserves so that you will be safer and sounder or, at the same time, the SEC is saying, no, you have too much in reserves and, in fact, we believe that you are approaching the point of managing earnings, which is not good for the public markets.

This is not fiction. This is real. It is happening today. One of the concerns I have is how we deal with two regulators, and we deal

with it in banking all the time, but it is a problem when you get two regulators with different views, and both of them having the power to regulate a single financial institution.

One of the concerns, not to drag it on, but the safety and soundness regulators, which I have already mentioned the names, have the power to remove an executive or remove a member of the board of directors. The SEC has the power to send you to jail. And so, at the end of the day, the boards tend to be more responsive to the SEC because of the more power and the threat of criminal activity if, in fact, you do not follow their rules.

Senator BENNETT. I assume, when you go to jail, you are also removed from the board.

[Laughter.]

Mr. HEMINGWAY. Well, you know of an incidence in Utah where that was not the case, but that is usually the case.

[Laughter.]

Senator BENNETT. Well, let us go back to Senator Bunning's comment, then, when he raised the suggestion that it was potential registration with the SEC that caused Freddie Mac to get in the situation where they restated their earnings. Do you accept that as a cause-and-effect relationship?

Mr. HEMINGWAY. I think there is another issue there, is they changed accountants. You will probably recall that Arthur Andersen was the accountant for Freddie Mac, and I am personally not aware which of those instances caused this to come to light; was it the new accounting firm or was it registering with the SEC, a combination of both or neither. I do not know, personally.

Senator BENNETT. Before I turn it over to Senator Sarbanes, does anybody have a comment on the conflicting stresses created by the two types of regulators that Mr. Hemingway has raised?

Mr. MIDDLETON. Senator, I support that. My company is an SEC-registered bank as well, but we registered with the SEC because it was in the best interest of our business plan, and I worry about the mission of the FHLB we have a statutory mission plan, if you will, by Congress.

Senator BENNETT. Did you have an option not to register with the SEC?

Mr. MIDDLETON. Yes, sir, but because of the number of shareholders, we registered. We could have restricted the number of stakeholders had we want to do so.

Senator BENNETT. I see.

Mr. MIDDLETON. That is a choice, and that is why it is a voluntary registration. I just worry, as a deep user of the Federal Home Loan Bank, is that the difficulties that have to be worked through can be worked through, and a disclosure, in SEC format is easy to obtain, and everybody has recognized that this is always good for a GSE, but we do need to have sustainable, written agreements that say, here is how we are going to interpret issues such as joint and several obligations. This is how we are going to interpret issues such as REFCORP. This is what happens if the mission requires specific action—how do we serve the mission if it conflicts with the SEC's decisions.

So there are very difficult things to work through, and I can assure you—I am on the Audit Committee and I chair the Finance

Committee of the Atlanta Bank—we have spent a lot of hours and a lot of resources making sure that we do this thing in an appropriate manner because, at the end of the day, corporate law prevails. The prudent business judgment decision provision of the duty of care prevails. So, when we vote for this, we must know that these critical issues are resolved so that we will not hurt and do no harm to the System.

Senator BENNETT. Okay.

Mr. MIDDLETON. Does that help you?

Senator BENNETT. That is helpful. Ms. Bair, do you want the last word on this?

Ms. BAIR. If I could just add, my sense is that the prospect of SEC registration was added impetus to the Freddie Mac board to get their house in order, so to speak.

I would also say I worked with the SEC for many years as the head of Government Relations for the New York Stock Exchange. It is a disclosure-based regulatory regime. It is not a safety and soundness regulatory regime vis-á-vis publicly traded companies. So, even though there have been conflicts between the bank regulators on the loss reserves, that has been not a safety and soundness issue for the SEC so much as it has been a managed earnings issue, a disclosure issue.

It is also ironic, you bringing it up, because I have heard another concern may be that the low-level retained earnings in the System, which goes counter to where you might think the conflict was with the SEC in the loss reserves.

But my sense is they are not a safety and soundness regulator. They are a disclosure-based regime, and that is the approach they take.

Senator BENNETT. I see.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

I would like each of the panelists very succinctly, if they could, to state what they think is the proper regulatory structure for the Home Loan Banks.

Senator BENNETT. Mr. Rice, let us start with you and go on down.

Mr. RICE. The proper regulatory structure is——

Senator BENNETT. Here, the buck always starts in the middle of the table.

[Laughter.]

Mr. RICE. You are right.

The proper regulatory structure is the structure, as it exists in the Finance Board now. If it is to move, I would hope that you would preserve the structure that is there, which has mission and safety and soundness tied together, the notion of respect for the cooperative, which makes it different than the other housing GSE's, and to make sure that the return on the investments that are made in the system go to their members, rather than to shareholders. So, I see that structure as being a very solid structure.

Mr. MIDDLETON. Let us go to the users of the System, not the community banks, but the purchasers of the consolidated obligations. What do those users need? They need a very strong inde-

pendent regulator of a GSE, and that establishes credibility that their investment is safe and sound.

Ms. BAIR. I would hope that there is, as I said in my written testimony and oral statement, I believe that the broader the constituent base of the regulator, the stronger or the better position a regulator is in to be independent and not captive of a particular point of view. I think it will be a stronger regulator if the Federal Home Loan Bank System, and perhaps all other GSE's, are included in this new regulatory entity that it looks like we are on track to create.

I would hope that this new regulator, it is not worth doing, unless the quality and credibility of the regulatory regime is significantly enhanced. I would hope we would be designing a system that would parallel the supervisory quality and professionalism that you get with OCC and OGS, including accreditation standards for examiners, you know, the overwhelming bulk of the budget going to safety and soundness oversight, not mission promotion or housing promotion.

I think those are the things that the market needs to be sure that these things that we have created that do perform, all three, perform extremely significant and important roles in the housing market are run in a safe and sound manner.

Senator SARBANES. What are the roles that they perform in a housing market?

Ms. BAIR. The traditional role has somewhat been debated because they are getting into each other's line of business right now. But the traditional role has been for Fannie and Freddie to purchase and either hold, in portfolio or securitized mortgages, mortgages that come within the conforming limits set by HUD.

The Federal Home Loan Bank System's job has been to provide advances, loans to its members. Its focus is on the institutions, as opposed to direct purchase of loans, which are collateralized by mortgage assets provided by the members.

They are two distinctly different, somewhat competing roles, and since that, you can go to two different places for your funding. You can sell your mortgage to Fannie and Freddie or you can get an advance from the Federal Home Loan Bank System, but now we have a situation——

Senator SARBANES. I understand that the majority of the loans held by the Bank System are jumbo loans, beyond the conforming limits; is that correct?

Ms. BAIR. For collateral?

Mr. RICE. No, they are not.

Mr. HEMINGWAY. They do not buy jumbo loans.

Senator SARBANES. Are you telling me the Home——

Ms. BAIR. I think by regulation——

Senator SARBANES. —the Home Loan Bank system holds only conforming loans?

Mr. RICE. Yes, that is correct.

Mr. HEMINGWAY. The Mortgage Purchase Program will not buy jumbo mortgages.

I believe you are talking about the Mortgage Purchase Program——

Ms. BAIR. No, he is talking about——

Senator SARBANES. I am talking about the collateral for securing advances.

Mr. HEMINGWAY. Oh, excuse me.

Senator SARBANES. What is the answer to that?

Mr. HEMINGWAY. Whatever the bank pledges. I mean, jumbo mortgages qualify as collateral, as do conforming mortgages. It is whatever the Bank happens to have available to pledge. But in the Mortgage Purchase Program, you cannot, a bank cannot sell, a member cannot sell jumbo mortgages to the Home Loan Bank, only conforming mortgages.

Senator SARBANES. What about a regulator?

Mr. SMITH. I would just like to echo what we heard. I think the key point is a strong, credible, and independent regulator for the Home Loan Bank System.

Mr. HEMINGWAY. I would agree, a strong independent regulator. I would just add to it, in my banking back——

Senator SARBANES. Those of you who are saying that, is it your view that you now have such a regulator?

Mr. SMITH. Yes.

Mr. MIDDLETON. Yes.

Senator SARBANES. Ms. Bair is no.

[Laughter.]

Mr. MIDDLETON. Does it vary by the volume of the affirmation?

[Laughter.]

Senator SARBANES. What is your——

Mr. MIDDLETON. It is my understanding that the credit markets are very efficient, and they recognize that we have a very strong, safe, and sound——

Senator SARBANES. What is your view, expressed by some, that the exposure to risk that the Home Loan Bank System is engaged in is increasing and that poses a potentially significant public policy question?

Mr. RICE. I believe——

Senator SARBANES. Do you think there is nothing to that?

Mr. RICE. Oh, no, on the contrary. I believe that as we progress in this program, we are adding the resources, we are changing our models, to take into account this new business activity, and we will add the necessary resources to maintain a safe and sound operation.

There are a different analytics that go with it, and we are recognizing what those are and investing in the people that are necessary.

Senator SARBANES. When we say "we," who do you——

Mr. RICE. Our bank, I am sorry.

Senator SARBANES. Your particular bank.

Mr. RICE. My particular bank. I cannot speak for all of the others, but I think almost every bank that is looking at MPP are making those decisions.

Senator SARBANES. The fact that you just said you cannot speak for the others leads me to my next question. I am moving quickly here because we have limited time.

One observer described a system with joint and several liability with different capital structure as akin to 12 people with their shoelaces all tied together, but running at different speeds, and

concluded that one of them is bound to fall on his face. And, of course, this leads to a number of concerns about the problem of moral hazard, with respect to the Home Loan Bank System.

In a system where the Banks are doing highly collateralized advances, the issue raised by joint and several liability is muted. That is at a lower order of concern, I think, because of the highly collateralized advances that you are operating with.

But now the System is expanding into new areas. Proposals to restructure the System to allow multidistrict membership have emerged. I must say, in both instances, I, it is my own position, that the board cannot do this without coming back to Congress for a statutory change.

Senator BENNETT. If you had been here, Secretary Abernathy would have taken the same position.

Senator SARBANES. Yes. If banks are put into a position of competing with each other for members, for example, as they would be under multidistrict membership, or for business with each other's members, as in the Shared Funding Program, what danger do you see in the possibility that Banks would engage in a race to the bottom, relaxing collateral, capital standards, and others in order to attract or retain members?

The GAO said, "Under the joint and several structure, the potential for moral hazard exists; that is, Federal Home Loan Banks may have incentives to take financial risk, knowing that their losses would be covered by other Federal Home Loan Banks or ultimately by the Federal Government."

What is your view of that?

Mr. RICE. That is a big question. I will take them in pieces.

Number one, I really do believe that the way in which we are managing mortgage purchases, and the way in which the Finance Board reviews it, and through the examination of safety and soundness, I do not see that risk growing. And I think that the oversight that we have from our Board, and the way in which we direct profitability and the like, are well served in this process.

Senator SARBANES. When you say "by our board," you mean the Seattle Board?

Mr. RICE. Our board of directors of the Seattle Bank. But at the end of the day, all Banks are examined. All Banks' capital plans have to be approved by the Finance Board. There is oversight over all of the Banks, and I think that that oversight is the protection that you get in managing these programs.

The second issue that you have on multidistrict, I believe that the degree of consolidation that has gone on in the System necessitates some direction about modernization and accepting what is there. Whether that is the Congress' job or not, I think that if Congress chooses to move in that area, then I think it can resolve that issue, but we are not moving for multidistrict. The chairman of the Finance board is not entertaining any notion, and I do not think there will be a proposal before the Finance board to do so.

I forgot the last one, but I will defer to my colleagues.

Senator SARBANES. Mr. Middleton, do you want to address any of that?

Mr. MIDDLETON. May I just address components of it, Senator? [Laughter.]

With respect to the multidistrict, the Atlanta Bank raises a concern that we think it might introduce unhealthy competition, but I think, in light of the reality of what is going on in the financial markets, perhaps it should be looked at by somebody in authority. So whatever mode that you choose is fine.

The purchase of member assets, I can assure you that at the Atlanta Bank we just completed an exhaustive strategic plan that we have to do by regulation. And one of the directives that the board gave to management and ensured that we are properly allocating the budgeted resources that are sufficient to assure competent staffing in place prior to any significant growth or expansion of a new business product line. We would do in that measure normal banking circles, because we all have a day job at our banks.

I can assure you that we devoted a tremendous amount of resources and discussion to the endeavor. We are not going to eliminate risk. Our job is to manage risk. We want to manage risk in the most prudent manner possible. So that is at the forefront of our directorate at the Atlanta Bank.

Senator SARBANES. Let me throw another factor into the mix as we proceed along. As I understand it, the bulk of Federal Home Loan Bank advances go to a small number of very large members. The System has over 8,000 members, but the largest 1 percent of its members account for 50 percent of the advances. In some Federal Home Loan Banks, the concentration is even higher. In San Francisco Bank, 80 percent of the advances go to only five institutions.

I guess that raises the question, you know, what is the purpose of the System and why should the Home Loan Banks be devoting or providing low-cost funding to such large institutions which have direct access to the capital markets themselves? Should we graduate them from the Federal Home Loan Bank System at some point?

I mean, what is the purpose of this? I mean, from the point of view of the institution, it is a good deal, but what is the public purpose of it? And why are we, in effect, running perhaps a significant public risk in order to do this?

Sheila, why do we not go to you here.

Ms. BAIR. Well, I am asking the same question, Senator. I do not understand. I believe Congress's most recent pronouncement on the System, in Gramm-Leach-Bliley, clearly put an emphasis on community-based smaller institutions. I do not begrudge the ability of a large institution to use the System. They do, they always have, and they should continue in the traditional line of business of advances.

But to take on these new controversial business lines and new risk, for a service that is being more predominantly used for large mortgage originators, it does not, you know, they have a lot of sophistication on their own to manage interest rate risk associated with mortgage portfolios. Why do they need the Federal Home Loan Bank System to be stepping up to the plate and providing this service? I do not understand it either.

I think that it is telling that even those large originators are starting to get a little worried, I think, because the regulatory structure that was set up assumed a system that would continue

its traditional line of business of fully collateralized advances, which is a very low-risk business. The lines that they are getting into now are not low-risk businesses. And if this is the direction the System is going to take, then they need dramatically enhanced regulatory scrutiny, which is I think why world savings are calling for concurrent action on the Federal Home Loan Bank System as it appears Congress moves toward the creation of a new enhanced regulator at Treasury for Fannie and Freddie.

Do not forget, a lot of these large and small institutions hold a lot of system capital stock. And if the System gets in trouble, that stock is going to be in trouble, too, which could have systemic implications for the banking system.

Senator SARBANES. I might note, in that regard, we just received a letter from Washington Mutual:

The housing GSE's should have a strong regulatory oversight structure that ensures both the safe and sound operation of the GSE's and the fulfillment of their housing missions. The best way to assure this goal would be for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to be regulated by an independent agency within the U.S. Treasury Department.

The Agency should have a single director and should be funded through user fees, like the other bank regulatory agencies under Treasury, with appropriate recognition of the unique nature of the Federal Home Loan Banks as cooperatives, compared to the other housing GSE's, which are publicly traded companies.

Mr. Chairman, I presume this letter is in the record, but, if not, I would like to put it in the record.

Senator BENNETT. It shall appear in the record.

[The letter follows:]

Mr. SMITH. Back to, in terms of the large institutions, the first point here is to effect the housing market for consumers, and all consumers do not use small institutions to get their mortgages. Many consumers use large institutions. To the extent we are able to effect the cost of funds at those larger institutions, it then flows through to the same consumer base.

The second thing, when you look at our concentrations, our member base mirrors the industry. If you look at the percentage of asset distribution in the banking industry and compare it to the Home Loan Banks, we mirror that. We are a little highly weighted to the community institutions, the very small ones, but essentially we mirror the industry, and the industry is highly concentrated in its asset holdings. So, as a result, those are the institutions that typically are going to borrow more money.

And then, finally, in terms of our business model, the larger institutions provide us with scale, and that scale flows through to the small institutions. One thing you have to remember from my testimony is our boards are primarily controlled by elected directors from community and financial institutions.

If there was a concern that the larger institutions were being treated in any way better or advantageously relative to those institutions, I think our boards would be more than happy to tell us to knock it off.

Senator SARBANES. Did you want to add anything, Mr. Hemingway?

Mr. HEMINGWAY. No.

Senator SARBANES. I am not pressing you to do so, but I have one other question I want to ask, Mr. Chairman.

Senator BENNETT. Sure.

Senator SARBANES. You have been very generous with the time.

Senator BENNETT. Well, this has been a worthwhile exchange.

Senator SARBANES. Thank you.

Some time ago the Atlanta Bank issued a notice that it would not accept as collateral any loans that included single-premium credit insurance. As far as I know, no other bank has yet followed suit, nor have other banks taken any of the other steps, such as reducing prepayment penalties that one or more of the other housing GSE's have taken, let alone some of the moves with respect to best practices that lenders of their own volition or perhaps because of prompting have also taken.

Isn't this an area where the Home Loan Banks can make a real contribution to the reduction of predatory lending?

Mr. RICE. Yes.

Senator SARBANES. Mr. Smith.

Mr. SMITH. Yes.

Senator SARBANES. Mr. Hemingway.

Mr. HEMINGWAY. It sounds like a good idea to me.

Senator SARBANES. Yes, well, why do you not at least do what the Atlanta Bank——

Mr. HEMINGWAY. I suspect it will be on the next agenda, Senator.

[Laughter.]

Ms. BAIR. Let the record show we all agree on that one.

[Laughter.]

Senator SARBANES. Thank you very much.

Senator BENNETT. Thank you, Senator.

And, again, thanks to the panel. This has been most informative. We appreciate your patience and your persistence in responding to the questioning of the Subcommittee.

The hearing is adjourned.

[Whereupon, at 4:28 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional materials supplied follow:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

Mr. Chairman, I would like to thank you for holding this important hearing and I would like to thank all of our witnesses for testifying today.

The Federal Home Loan Bank System has brought the American Dream of homeownership to millions in this country. The Cincinnati Federal Home Loan Bank, which represents the Commonwealth of Kentucky, has helped many in my State achieve that same dream. But with the troubles recently experienced by Freddie Mac and given the changing world of the Federal Home Loan Banks, it is very timely that you are holding this hearing here today.

There are many issues facing the Home Loan Banks, multidistrict membership, mortgage acquisition programs, SEC registration, and regulatory structure are all questions that are before the banks today. In the past, Members of this Committee have brought up questions about the salaries of the Home Loan Bank presidents. I intend to bring up some of these issues in the question and answer period.

And I thank the Chairman for bringing in these witnesses. I think we have just about everyone connected to the Federal Home Loan Banks covered today.

I look forward to all of your testimony and to talking about some of these issues during the question and answer period.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I want to thank Chairman Bennett for holding this hearing to discuss the Federal Home Loan Bank System and the integral role it plays in providing liquidity to the U.S. housing markets. The Federal Home Loan Banks provide the largest private source of residential mortgage and community development credit in the United States. The Congress, the Federal Housing Finance Board, and the Banks themselves have the important task of assessing and updating the Federal Home Loan Bank System in order to make the changes necessary to ensure its continued success in fulfilling and executing its mission.

As Chairman of the Housing and Transportation Subcommittee, I have particular interest in and appreciation for the crucial role that the Federal Home Loan Bank System plays in promoting affordable housing in our country. The Banks' Affordable Housing Program (AHP) is the largest privately funded grant program for housing in the country, and key in financing affordable housing efforts through each of the Banks. In 2002, the Federal Home Loan Banks contributed $199 million toward low-income housing through the AHP program. The Community Investment Program (CIP) is also instrumental in funding community and economic development projects throughout the country.

The unique aspect of the Federal Home Loan Bank System that contributes to its success, is the ability of each Bank to develop its own programs in response to the needs of its membership. I am particularly appreciative of the Rural First Time Housing Program (RFHP), the Community Housing Program (CHP), the Rural Technical Assistance Program (RTAP) and the Community Development Program (CDP). These specific programs of the Federal Home Loan Bank of Topeka help aid homeownership and community development in Colorado. The Topeka Bank plays a vital role in providing liquidity to the independent community banks in Colorado so that they can, in turn, address the affordable housing andeconomic development needs of Colorado communities.

I would like to thank each witness for appearing before the Subcommittee today to address the Federal Home Loan Bank System and its role in the U.S. economy. I look forward to your testimonies.

PREARED STATEMENT OF WAYNE A. ABERNATHY

ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS
U.S. DEPARTMENT OF THE TREASURY

SEPTEMBER 9, 2003

Thank you, Chairman Bennett, Ranking Member Johnson, and Members of the Subcommittee for this opportunity to testify today on the Federal Home Loan Bank (FHLBank) System. The Department of the Treasury is keenly interested in the operations of the Federal Home Loan Bank System because of the important responsibility that the Congress has placed with the Federal Home Loan Banks to enhance

the liquidity of financial institutions, particularly as the Federal Home Loan Bank members meet such important community needs as promoting homeownership.

The housing finance market in the United States is the broadest, deepest, and most successful housing finance market in the world. That market is supported by a complex financial services infrastructure, which includes depository institutions, mortgage brokers, mortgage bankers, mortgage insurers, and a variety of other capital market intermediaries. Prominent among capital market intermediaries that make up that infrastructure are the housing government sponsored enterprises (GSE's)—Fannie Mae, Freddie Mac, and the FHLBank System.

The FHLBank System has had a long history of supporting housing finance in America. Congress created the FHLBank System in 1932 in response to a Depression-era liquidity crisis in housing finance. The FHLBank Act directs the FHLBanks to make loans—called advances—to eligible members. Advances traditionally served the role of providing thrifts access to reliable long-term funding for mortgage lending and as a source of liquidity to help thrifts finance deposit outflows without calling or selling their mortgages. Over time, Congress has expanded the System's membership base beyond thrifts, but the primary function of advances has remained relatively constant. Today, financial markets and our Nation's housing finance system bear little resemblance to the one that existed when the FHLBank System was created.

It is in that light that I would like to focus on three topics this morning: The need for the FHLBanks to voluntarily register with the Securities and Exchange Commission (SEC) under the terms of the Securities Exchange Act of 1934; the FHLBank Act and the activities of the FHLBank System; and Treasury's current detailed review of the FHLBank System.

Voluntary Registration with the SEC under the 1934 Act

The observance of good, fundamental practices of corporate governance is a high priority of this Administration. Foremost among such practices is regular, comparable, quality disclosure of corporate financial conditions. A key part of that commitment is improving the quality of corporate disclosure requirements by the GSE's, which is why for more than a year the Administration has been urging *all* GSE's to comply with the same corporate disclosure requirements of the Securities Exchange Act of 1934, as interpreted and applied by the SEC. Investors in GSE securities should have access to the same corporate disclosures as they have for other companies who publicly offer their securities for investment.

We are pleased that Fannie Mae has complied with this request to voluntarily register and made its first disclosures under the 1934 Act in the first quarter of 2003. Freddie Mac has also agreed to register with the SEC, though we are disappointed to learn that Freddie Mac may not be registering until sometime in 2004. The sooner that they register with the SEC the better for them and their investors, though we fully concur with their intention that such registration and the financial disclosures that this step entails fully meet the high standards that are required.

The Administration has continued to urge the FHLBanks to move forward with voluntary registration with the SEC under the 1934 Act. Some have argued that the structure of the FHLBank System and the unique characteristics of the FHLBanks in comparison to Fannie Mae and Freddie Mac lessen the need for registration under the 1934 Act. Certainly there are differences: When the FHLBank System was created in 1932, it was created with geographically limited regional banks. Each regional Home Loan Bank is cooperatively owned by its members, and its capital stock is not publicly traded. The 12 FHLBanks raise funds in the capital markets by issuing consolidated obligations for which they are jointly and severally liable. All of these facts are important and must be—and I believe can be—taken into account.

However, the differences between the FHLBanks and the other GSE's do not change the fundamental fact that the FHLBanks are significant participants in our capital markets by any measure, and that investors should have the same information regarding the condition of the Home Loan Banks as they have for other significant capital market participants. The facts make this case dramatically:

> At the end of June, the FHLBanks had outstanding consolidated obligations of $712 billion, of which bonds with original maturity of 1 year or longer constituted $556 billion of the total.
>
> The individual FHLBanks are each large financial institutions. As of year-end 2002, the largest Home Loan Bank (the FHLBank of San Francisco) had $135 billion in total assets, the smallest (the FHLBank of Topeka) had $33 billion in total assets, while the average among the 12 banks was $58 billion in total assets. Even the smallest Federal Home Loan Bank would rank among the top 40 commercial banks in the United States.

Federal Home Loan Bank registration under the Securities Exchange Act of 1934 is an important step in increasing the transparency of the FHLBanks' financial information to investors. The recent problems of Freddie Mac and a credit rating agency's revision of its outlook for one of the Federal Home Loan Banks from stable to negative illustrate the need for investors to have a more accurate picture of the GSE's' financial operations. Following Federal Home Loan Bank registration under the 1934 Act, investors would have access to the FHLBanks' financial information through the same forms and methods as those that apply to other companies that sell publicly traded securities. Investors would benefit from the added oversight of the SEC, both in terms of reviewing the Federal Home Loan Banks' financial disclosures and through the uniform enforcement of current standards. And investors would have the basis for making comparable evaluations of the financial conditions of the variety of institutions competing for their investment dollars. Our system of securities regulation should offer investors nothing short of that standard.

The continued operation of the FHLBanks outside of the SEC-administered corporate disclosure regime is inconsistent with our objective of a sound and resilient financial system. We understand that the FHLBanks have some remaining concerns with how certain aspects of their business operation would be treated if they registered under the 1934 Act. I would remind them and all concerned that the Federal Home Loan Banks are not the only corporate institutions in America that have unique characteristics. It was specifically in order to deal with the variety of corporations in the Nation—while still preserving a high standard of comparable disclosures—that the SEC was given its exemptive authority under the securities statutes. Given the flexibilities that the SEC has to address the individual circumstances of the various registrants under the 1934 Act, we are confident that the Federal Home Loan Banks' concerns can be worked out with the SEC.

We appreciate the discussions that several of the Banks have had with the SEC earlier in the year, and we look forward to those discussions being renewed in the immediate future, within a context of acceptance of the public interest that would be served by the Federal Home Loan Banks registering under the terms of the Securities Exchange Act of 1934. We understand that the Board of Directors of the Federal Home Loan Bank of Cincinnati recently announced the Bank will be taking the next step in the process of voluntary registration with the SEC. In a recent letter to Secretary Snow, Housing and Urban Development Secretary Martinez, and Federal Housing Finance Board Chairman Korsmo, the Board of Directors of the Federal Home Loan Bank of San Francisco expressed their goal "to enable the Federal Home Loan Banks to become role models for corporate transparency." That is our goal as well, to which Federal Home Loan Bank registration under the Securities Exchange Act of 1934 is essential.

Multidistrict Membership, In Context

In chartering each of the housing GSE's, Congress described the markets to be served by these GSE's, the financial activities these GSE's should undertake, and created a regulatory structure to oversee the GSE's and their activities. While there have been and continue to be debates over a number of Home Loan Bank activities and how these activities fit within the statutory confines of the Federal Home Loan Bank Act, one current issue—the question of multidistrict membership—raises particular concern. The Federal Housing Finance Board (Finance Board) has received a number of petitions requesting that Federal Home Loan Bank members be permitted to join more than one Federal Home Loan Bank. The Finance Board has analyzed this issue, obtained outside legal counsel on its authority to authorize multidistrict membership, and solicited views from interested parties.

All of that is well and good and appropriate. A lively discussion of policies and programs is healthy. But the appropriate forum for the resolution of these issues must be kept in mind. As the Treasury Department has written in a comment letter to the Finance Board, regardless of whether allowing multidistrict membership is wise, a plain reading of the statute finds little room to conclude that the Finance Board has the legal authority to approve it. It provides:

> An institution eligible to become a member under this Section may become a member only of, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's principal place of business, or of the bank of a district adjoining such district, if demanded by convenience and then only with the approval of the Board.[1]

[1] 12 U.S.C. § 1424(b).

This view is reinforced by the comments of Assistant Legislative Counsel Mr. John O'Brien (a principal drafter of the Federal Home Loan Bank Act) in response to questions regarding the Federal Home Loan Act at a Senate hearing in 1932.

> [I]t was not the desire, say, for members in South Carolina to borrow of a New York bank, because it would mean too great a concentration at the New York bank. If the New York bank happened to do better than a South Carolina bank, all members would go there. There is the opportunity in the bill for a member whose principal place of business is in one district to belong to a bank in the adjoining district, but outside of that there is no provision. It is impossible under the terms of the bill for a company doing business in New York to belong to a South Carolina bank.[2]

To say this is not to render a policy point of view. There are compelling arguments on both sides of the question with regard to the advisability of multidistrict membership. Clearly our financial system has changed dramatically since the System was established in 1932 and the predecessor to the current regulator created the 12 banks, and determined their locations and boundaries. In the intervening years, however, Congress has revised the governing statutes on several occasions. It is to the Congress that these arguments should be offered and where any change in the statute will have to be made.

To some, multidistrict membership represents a natural progression in the modernization of the FHLBank System. We would only add our view that if multidistrict membership is considered, it should be done within the general context of evaluating the Federal Home Loan Bank System's charter.

Treasury's Review of the FHLBank System

Perhaps the time for such a review is near. Earlier this year, I requested the Office of Financial Institutions Policy at the Treasury Department to conduct an in-house review of the Federal Home Loan Bank System, with particular—but not exclusive—consideration of the effect of the changes enacted as part of the Gramm-Leach-Bliley Act of 1999 (GLBA). As I announced at that time, the review would consider:

- how these changes have affected the ability of the Federal Home Loan Banks to meet their statutory mission;
- implications for the financial strength of the Banks individually and the System in general;
- how the business operations of the Banks contribute to accomplishing their statutory mission;
- issues regarding governance structure and management, including executive compensation;
- effect of new capital structures on operations; and
- other issues regarding the strength of the System and the structure of Federal oversight.

We are now about 4 months into that process, nearing completion of the first phase. In the first phase, the staff conducted a general review of the literature, discussions, debates, and developments to put a sharper focus to the questions to be examined. Now they are preparing to go into greater detail. The initial step in the second phase will be to discuss specific topics with the Finance Board.

Some of the issues we will be looking at in greater detail include:

Capital Structure

GLBA significantly changed the capital structure of the Federal Home Loan Banks and provided greater flexibility in the development of capital plans. What are the similarities and differences among the various capital plans? How have the risk-based capital requirements been implemented? How will new capital plans impact the Banks' investment portfolios?

Membership

GLBA eliminated mandatory membership requirements for Federal savings associations and permitted broader access to FHLBank membership for community financial institutions (insured depository institutions with less than $500 million in total assets). What has been the impact of these changes in membership participation? Have those changes affected governance of the Home Loan Banks?

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[2] *Id.* (citing Hearings on S. 2959 concerning creation of the FHLBank System), 72nd Cong., 1st Sess (1932), at 199.

Advances and Collateral

The GLBA provided community financial institutions with a broader range of eligible collateral for FHLBank advances. The Finance Board reports that as of June 30, 2003, expanded collateral from community financial institutions represents approximately $10.6 billion of the $486 billion in outstanding advances. How has this provision been implemented by the FHLBanks and what factors impact community financial institutions use of the broader range of eligible collateral?

In addition to evaluating these specific legislative changes, over the last decade the activities of the Federal Home Loan Banks have evolved in many ways. Some specific activities that we will be focusing on include:

Balance Sheet Developments

How have key activities (advances, investments, and mortgage purchases) of the System and the individual Home Loan Banks evolved over the last decade, and what does this imply for the future of the System?

Advance Usage

What are the characteristics of FHLBank advance users? What types of advances are most commonly used by System members? What impact is it having on the activities of the members and their ability to serve their customers?

Again, I would like to emphasize that Treasury's review of the Federal Home Loan Bank System is part of what we normally do at Treasury, and what I envision for our current review is a more specific look at how the changes made to the FHLBank System as part of GLBA have been implemented. Treasury is not primarily a regulatory agency. We see as part of our important function, however, providing executive branch oversight of the activities of the independent financial regulators, and this study is part of meeting that responsibility.

And before I leave this subject, with regard to regulatory oversight of the FHLBank System, I would like to commend Finance Board Chairman Korsmo for the increased emphasis he has placed on safety and soundness oversight, in particular the emphasis he has placed on the supervision and examination function. In recent years, many observers have pointed to weaknesses in the Finance Board's supervision of the Federal Home Loan Banks. Chairman Korsmo has given major focus to strengthening the examination process, doubling examination staff on the way to tripling it. I have no doubt that even further increases will be made as necessary.

As another related aside, I would like to raise a point about a legislative proposal regarding the membership of privately insured credit unions in Federal Home Loan Banks. As part of that proposal, private insurers of credit union deposits would be required to submit annual audit reports to the National Credit Union Administration (NCUA). In addition, upon the NCUA's request, the appropriate State supervisory agency would be required to provide the NCUA with examination reports of private deposit insurers. We are concerned that the provisions related to the NCUA could give the false impression that the NCUA has oversight authority over the private deposit insurers of credit unions and that the Federal Government somehow stands behind the private insurers. Not only would that be a terribly false impression potentially harmful to depositors, but it would also remove some of the market discipline that is so essential to the successful functioning of any private insurance program.

Conclusion

The Federal Home Loan Bank System presents policymakers with issues that deserve continued attention. The System has historically played an important role in our Nation's housing finance markets. We must continue to evaluate the System to ensure that it is achieving the objectives set forth by Congress, meeting the needs of our communities that might not otherwise be met.

Thank you again for providing me with the opportunity to discuss these important issues with the Subcommittee today.

PREPARED STATEMENT OF JOHN T. KORSMO

CHAIRMAN, FEDERAL HOUSING FINANCE BOARD

SEPTEMBER 9, 2003

Thank you, Chairman Bennett, Ranking Member Johnson, and distinguished Members of the Subcommittee on Financial Institutions. I appreciate the oppor-

tunity to speak with you today about the Federal Housing Finance Board (Finance Board) and the Federal Home Loan Bank System.

Many important issues are facing the Nation's Government Sponsored Enterprises (GSE's), including, certainly, the Federal Home Loan Banks (Banks). I highlight today the aggressive steps we have taken at the Federal Housing Finance Board, the System's regulator, first, to strengthen the Agency's oversight capabilities; and second, to improve financial disclosures by the Federal Home Loan Banks through voluntary registration with the Securities and Exchange Commission (SEC).

These initiatives will benefit not just the Federal Home Loan Banks and their member institutions, but also the investors that purchase the Banks' debt, the taxpayers, and ultimately, the homebuying public who are served by the housing finance mission of the Banks.

As requested in Chairman Bennett's invitation to this oversight hearing, I will also address the issues of multidistrict memberships in Federal Home Loan Banks and the Banks' various Acquired Member Asset programs (AMA).

Allow me to begin by providing a brief overview of both the Federal Housing Finance Board and the entities we regulate, the 12 Federal Home Loan Banks and the Office of Finance.

The Federal Housing Finance Board is an independent agency in the executive branch of the U.S. Government, with a five-member Board of Directors, four appointed by the President and one ex-officio member, the Secretary of Housing and Urban Development. Created to take over certain duties of the Federal Home Loan Bank Board by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Finance Board's primary duty is to ensure that the 12 Federal Home Loan Banks and the Office of Finance operate in a financially safe and sound manner.

In addition, the Finance Board ensures that the Federal Home Loan Banks carry out their housing finance and community lending mission and remain adequately capitalized and able to raise funds in the capital markets. The Federal Home Loan Bank Act requires the Finance Board to examine and report on the condition of each Federal Home Loan Bank at least annually. Finally, the Finance Board is a nonappropriated agency that enacts its own budget; it assesses the Banks for the costs of its operation.

The 12 Federal Home Loan Banks and their joint office, the Office of Finance, serve the public by promoting the availability of housing finance, including community lending credit, through 8,000-plus member institutions. The 12 Banks provide a readily available, low-cost source of funds to members and a secondary market facility for home mortgages originated or acquired by their members. The Banks are cooperatives; only members may own the stock of each Federal Home Loan Bank, and the members receive dividends on their investment. Insured banks, thrifts, and credit unions and insurance companies engaged in housing finance can apply for membership.

The Federal Home Loan Banks play a unique role in housing finance. They make loans, called advances, to their members and eligible housing associates (principally State housing finance agencies) on the security of mortgages and other collateral pledged by those members and housing associates. Advances generally support mortgage originations, provide term funding for portfolio lending, and may be used to provide funds to any member "community financial institution" (an FDIC-insured institution with assets of $538 million or less) for loans to small business, small farms, and small agribusiness. Because portfolio lenders may originate loans they are unwilling or unable to sell in the secondary mortgage market, Federal Home Loan Bank advances serve as a funding source for a variety of mortgages. This flexibility allows these advances to support important housing markets, including those focused on low- and moderate-income households.

Federal Home Loan Bank advances can provide funding to smaller lenders that lack diverse funding sources. Smaller community lenders often do not have access to funding alternatives available to larger financial entities, including repurchase agreements, commercial paper, and brokered deposits. The Federal Home Loan Banks give these lenders access to competitively priced wholesale funding.

The Federal Home Loan Banks principally fund themselves by issuing consolidated obligations, which are the primary obligation of a sponsoring Bank or Banks, backed by a joint-and-several liability guarantee of all Banks. Consolidated obligations outstanding at June 30, 2003, totaled $712.4 billion. This includes bonds (original maturity of 1 year or longer) of $556.2 billion and discount notes (original maturity of less than 1 year) of $156.2 billion.

Finally, a few more key figures: Total assets of the Federal Home Loan Banks stood at $812 billion as of June 30, 2003. Advances totaled $506.3 billion, which is

7.6 percent greater than 1 year ago. Viewed collectively, the Federal Home Loan Banks represent the third largest domestic banking organization.

Institutions of this size and importance to the Nation's housing market and economy in general clearly require a robust and capable regulator, and since President Bush named me Chairman in December 2001, I have sought to establish the Finance Board as just that.

Improvements in Safety and Soundness Oversight

Soon after I became Chairman, my Finance Board colleagues and I determined that the Finance Board lacked the necessary resources to effectively carry out its primary responsibility, that of overseeing the Federal Home Loan Banks and the Office of Finance for safety and soundness. Just one example demonstrates this point: The Finance Board had only eight bank examiners on staff to review and supervise a dozen financial institutions with, at the time, more than $700 billion in assets, more than $30 billion in capital, and some $650 billion in outstanding debt. Yet, the Agency also had an Office of Public Affairs with the same number of staff, eight. The relative allocation of resources simply did not meet the Agency's statutory mandates.

In addition to being understaffed, the examination function was also insufficiently focused on the Banks' risk assessment processes and the Banks' internal control systems. Such shortcomings had been identified in a 1998 General Accounting Office (GAO) report of the Finance Board's examination program, but had not by that time been addressed and corrected.

I immediately set out to respond to these problems, beginning with the recruitment of new leadership for the Agency's Office of Supervision. After a national search, the Finance Board hired a new director and a new deputy director of supervision, who between them have 40 years of regulatory experience with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC).

My Finance Board colleagues and I increased the resources available for supervision, expanding the Agency's examination staff to 17 full-time bank examiners. Our goal is to have 24 in place by the end of this calendar year, and 30 by the end of the next budget year.

The Finance Board is now conducting more thorough, risk-focused examinations, and communicating the results of those examinations more effectively to the Banks.

Examinations now recognize that banking—including AAA-rated, GSE banking—is a business of managing risks, and the responsibility of bank supervisors is to ensure that the institutions they regulate understand those risks and monitor and control them through prudent risk management practices.

To enhance analysis and oversight in the risk management area, we have established two risk units—a Risk Modeling Division and a Risk Monitoring Division. The Risk Modeling Division is responsible for the development of our asset/liability modeling and for monitoring the Bank's internal interest rate risk models. The Risk Monitoring Division pulls together all our data and the Banks' own financial reporting into a risk-monitoring framework.

We have hired an Associate Director for Examinations who oversees all our safety and soundness examiners. She has more than 15 years of bank regulatory experience with the FDIC. We also have hired a Senior Advisor to the Director of Supervision to provide support to the Risk Modeling and Risk Monitoring Divisions. That Senior Advisor possesses some 30 years of bank supervision, capital markets, and capital regulation experience with the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision.

While on-site examinations remain the primary tool of supervisors, the Agency now complements exams with off-site monitoring and regular communication with the Banks. Our new "Bank Analyst Program" charges a member of our Office of Supervision with following an individual Bank and reviewing monthly and quarterly financial reports for trends and changes, while also keeping abreast of issues in the financial and housing industries to determine their effect on each Bank.

Our Office of General Counsel has also assigned attorneys who serve as points of contact for the examiners on particular Bank issues.

In short, the Finance Board's safety-and-soundness oversight of the Federal Home Loan Banks has improved dramatically. We have more work ahead of us, to be sure, but the Finance Board is a much stronger and more capable regulatory agency than it was as recently as 12 months ago.

The 1998 GAO report also found that Finance Board examinations neglected the critical area of board governance at the Federal Home Loan Banks. To address this shortcoming, and as another element of our safety and soundness supervision, the Finance Board has undertaken a thorough assessment of corporate governance at

each of the Banks. This effort included the first-ever horizontal review—that is, a systemwide supervisory review of a single issue at each of the 12 Banks—which addressed the Banks' effectiveness relative to eight indicators of effective board governance.

Those indicators are:

- Engaged Board of Directors;
- Skilled Senior Management;
- Thorough Strategic Planning;
- Sound Risk Management;
- Robust Internal Control;
- Effective Audit Program;
- Strong Ethical Culture;
- Timely, Accurate, and Complete Communications.

The Finance Board's final report on this review includes a variety of general recommendations for improving corporate governance. The Agency also provided specific, confidential feedback to each of the 12 Banks.

The next step with respect to bank governance is a public hearing, tentatively scheduled for October 15. The Finance Board will solicit from the Banks, their member institutions, experts, and interested members of the public any ideas for reform in this important area. Input generated may be used in the design of proposals aimed at making the Federal Home Loan Banks role models in corporate governance.

Earlier this year, the Finance Board undertook a second systemwide horizontal review—that of the Federal Home Loan Banks' implementation of the statutorily mandated Affordable Housing Program (AHP). The AHP is a highly successful program that warrants a separate discussion and some background.

The Affordable Housing Program (AHP)

The Federal Home Loan Bank Act requires each Bank to establish and fund an Affordable Housing Program. Under the AHP, each Bank must annually contribute the greater of 10 percent of its net earnings for the previous year, or such prorated sums as may be required to ensure that the aggregate contribution of the Banks is at least $100 million. Actual contributions to the program were $199 million for 2002, and the contributions have exceeded $100 million each year since 1994.

AHP subsidies must be used to fund the purchase, construction, or rehabilitation of:

- Owner-occupied housing for very low-income, or low- or moderate-income (no greater than 80 percent of area median income) households; or
- Rental housing in which at least 20 percent of the units will be occupied by and affordable for very low-income (no greater than 50 percent of area median income) households.

In 2002, the Finance Board adopted a regulation enabling Banks to allocate annually the greater of $4.5 million or 35 percent of each Bank's AHP contribution to homeownership set-asides. Part of this increased funding authority helps Banks combine AHP subsidies with HUD initiatives benefiting minority, immigrant, and other first-time homebuyer families.

Since the inception of the AHP in 1990, the Federal Home Loan Banks have contributed $1.7 billion to the program, funding 236,596 rental units and 122,126 owner-occupied units. In 2002, the Banks committed $286 million to AHP projects.

The Finance Board appropriately devolved operation of the AHP to the individual Banks in the late 1990's, a valuable development because the Banks are best equipped to assess local affordable housing needs and build partnerships with local community groups and housing agencies.

Correspondingly, the Finance Board's oversight responsibility has grown with respect to the AHP to ensure proper and effective program operation. As such, we are following up the horizontal review with a new practice of examining each Bank's AHP once a year. These exams are performed by examiners and analysts whose specialized training has specifically equipped them for this task.

We are also preparing regulatory language intended to enhance the effectiveness of the AHP by permitting Banks more latitude in establishing the criteria to score applications. The goal is for Banks to be more responsive to local housing conditions. We also plan to streamline the application process to permit projects to proceed more quickly and with lower administrative costs.

AHP is truly one of the Federal Home Loan Banks' great success stories, and with rigorous oversight at the Federal Housing Finance Board, I am confident it will be even more successful in the years ahead.

Enhanced Disclosures

The other key initiative I wish to discuss today is enhancing the quarterly and annual corporate disclosures of the Federal Home Loan Banks.

In July 2002, the administration called on all Government Sponsored Enterprises to comply with the corporate disclosure requirements of the Securities Exchange Act of 1934, as interpreted and enforced by the SEC.

Fannie Mae and Freddie Mac, the other two housing-related GSE's, answered this call. Fannie Mae has already filed its first disclosures under the new SEC regime.

As Chairman of the Federal Housing Finance Board, I too am determined to hold the Federal Home Loan Banks to the highest standard of disclosure. Accordingly, I formed a working group from the Finance Board and the Federal Home Loan Banks to review the implications of acceding to the Administration's request.

Early this year, I concluded that voluntary registration with the SEC was indeed the best approach to providing enhanced public disclosure of the operations and finances of the Federal Home Loan Banks. I reached this conclusion based on two premises.

First, the Banks' long-term access to global capital markets will be enhanced by providing investors in consolidated obligations with maximum reliable transparency into the finances and governance of each of the 12 Banks. Markets function best, especially in times of stress, when needed information is readily available and reliable.

Second, as public trusts, these 12 GSE's have a duty to contribute both to the smooth functioning of capital and mortgage finance markets and to public confidence that the benefits of GSE status are used wisely.

At my urging, Federal Home Loan Banks and the staff of the SEC have held numerous meetings to address the process for voluntary registration, including methods for resolving several key disclosure and accounting questions.

The Board of Directors of the Federal Home Loan Bank of Cincinnati actively embraced the disclosure initiative as in the best interest of its members, voting in February to pursue voluntary registration. Last month, the Cincinnati board resolved to "actively engage, effective immediately, in the process of voluntary registration with the SEC of its member-held stock."

This summer, too, the boards of the Federal Home Loan Bank of San Francisco and the Federal Home Loan Bank of Atlanta resolved that if SEC registration was the determined course of action, it is their request that the Finance Board adopt a regulation requiring it.

In response to those requests, at its regularly scheduled meeting tomorrow the Finance Board will consider a proposed regulation requiring each Bank to register a class of securities with the SEC under Section 12(g) of the Securities Exchange Act of 1934.

The proposed rule provides for a lengthy, 120-day comment period, during which, I hope, the Banks will each meet with the SEC to work out the necessary details to effectuate registration and begin meeting the periodic financial reporting requirements of the 1934 Act.

The focus of the enhanced disclosure effort from the start has been to ensure that the Federal Home Loan Banks play their part, as Government Sponsored Enterprises, in contributing to the smooth functioning of the capital and mortgage finance markets. In the end, consistent and full disclosures of these institutions' finances and corporate governance also serve the public, who stand behind their charters as Government Sponsored Enterprises.

Acquired Member Assets (AMA)

I have been asked to address two other issues in my testimony today. The first of these concerns regulations governing the Acquired Member Assets programs, or AMA, of the Federal Home Loan Banks.

The 12 Federal Home Loan Banks are authorized to purchase single-family mortgages that do not exceed the conforming loan limit applicable to Fannie Mae and Freddie Mac, currently $322,700. The authority granted under the current rule (12 CFR Part 955) is an expansion and refinement of previous authority that had been granted to the Banks by a Finance Board resolution in 1996. That authority was challenged in 1997, a challenge rejected by a U.S. District Court in 1998. The U.S. Court of Appeals for the Fifth Circuit upheld the District Court's ruling in 2000, affirming the Finance Board's authority in this area.

There are currently two AMA programs—Mortgage Partnership Finance (MPF) and Mortgage Purchase Program (MPP). MPF is the older and larger program. Under the current AMA programs, a Bank may purchase mortgage assets from a member institution. The programs, like advances, provide member institutions liquidity for mortgage lending. In AMA programs, the member manages and bears

a material portion of the credit risk. Since the programs' inception in 1996, the Banks have purchased more than 600,000 loans. Approximately 75 percent of those loans were purchased under MPF and 25 percent under MPP. More than 95 percent of the total loan acquisition has occurred since 2000, the current AMA regulation having become effective on July 17, 2000.

On July 1 of this year, the Finance Board unanimously adopted and published for comment a proposed revision to the current AMA regulation. The Finance Board's intent is clearly stated in the preamble to the regulation, that is, to make the regulation more "effective and efficient in regulating the Banks' mortgage purchase programs." In the rule, the Finance Board also seeks to clarify and simplify the language of the current rule. The proposed regulation does not expand or alter the fundamental structure of the AMA programs.

The proposed regulatory changes also maintain or strengthen many appropriate safety and soundness provisions of the current rule, again reflecting the Finance Board's continued emphasis on improving its safety and soundness oversight of the Federal Home Loan Banks.

Safety and soundness provisions maintained or strengthened under the proposed rule include requirements that:

- All AMA must be at least investment grade when acquired by the Bank.
- The Bank must have in place a process and methodology to determine the required credit enhancement prior to acquisition of any asset and throughout the life of the asset on the Bank's books.
- The Bank must take remedial action by requiring the member to provide additional credit enhancement or hold additional capital if the estimated credit rating of the asset declines to below the rating required at time of acquisition.
- Insurers must be rated AA or better to provide a portion of the credit enhancement to the member institution selling assets to the Bank.
- Banks without risk-based capital structures in place must hold retained earnings for losses as support for the credit risk associated with any AMA estimated to be rated below AA.

In addition, the proposed regulation incorporates Finance Board criteria previously set forth in the preamble of the July 2000 final AMA rule outlining the circumstances under which Banks are permitted to acquire from members highly rated interests in pools of mortgages as an alternative to acquiring whole loans. Among the criteria is a requirement that all loans backing such interests must themselves be eligible for purchase by the Bank as AMA. As with any new AMA product, a Bank is only allowed to acquire such interests after its proposed program has been reviewed and approved under the Finance Board's New Business Activity regulation.

The proposal further seeks comment on whether the Finance Board should take measures to prevent a Bank from acquiring loans or assets backed by loans, through its AMA program, where the loans have features or were made under circumstances that may be considered predatory or abusive. The proposal also asks for comment on whether and how to limit Banks' authority to acquire such loans or assets backed by such loans.

The text of the proposed regulation maintains the current prohibition on purchases directly from affiliates of member institutions. In response to numerous requests from members using affiliates and subsidiaries for mortgage origination activities, the preamble does invite comment on changing current policy to allow affiliates owned and controlled by members to directly sell assets to Federal Home Loan Banks.

The importance of revising Finance Board regulations to better reflect the Agency's supervision approach argues for a constructive exchange among the interested public, Federal Home Loan Banks, and the Finance Board. It appears, however, that some may have misunderstood the intention of this proposed regulation.

As a result, in agreement with my fellow Directors, I will ask the Finance Board to vote at its regular Board meeting tomorrow to withdraw the present rulemaking. The proposed text will be revised and clarified to more clearly enunciate the principles I listed above, and the resulting proposed regulation will be voted on in a subsequent meeting. If approved by the Finance Board, the revised proposed regulation will be published for a 90-day comment period.

Multidistrict Membership

When I became Chairman of the Finance Board in December 2001, the multidistrict membership debate was already over a year old, having been prompted by regulatory requests filed in 2000 and 2001 by four Federal Home Loan Banks that had lost large members to mergers with institutions headquartered in other Federal

Home Loan Bank districts. A Solicitation for Comments on the issue was pending and remained open until March 2002.

When Congress created the 12 Federal Home Loan Banks 71 years ago, it anticipated that each member thrift institution would operate where its collateral was located, and at that time, that meant in its home State alone. The financial world, of course, has fundamentally changed since 1932, as has the membership base of the Federal Home Loan Banks now that membership is voluntary for all and open to commercial banks and credit unions, as well as thrifts and insurance companies.

With the advent of interstate banking and national holding companies, the Federal Home Loan Banks are operating in a different competitive environment than existed through most of their history. For Bank member institutions organized under certain holding company structures, multidistrict membership already exists. One hundred three holding companies, doing business in more than one Federal Home Loan Bank district through separately chartered subsidiaries, currently account for 451 distinct Bank memberships. Institutions that operate in multiple regions through a single charter, however, are precluded by Finance Board regulations from establishing similar operating arrangements with more than one Federal Home Loan Bank.

Let me make clear that, while it is my view that the Federal Home Loan Bank Act both empowers and obligates the Finance Board to continue regulating the terms of Bank membership to the extent necessary to ensure safe and sound operation of Banks, access by Banks to capital markets, and achievement of the Banks' housing finance mission, I am neither an advocate nor an opponent of expanding multidistrict membership in the Federal Home Loan Bank System.

When I became Chairman, I asked the four Banks seeking regulatory approval for multidistrict membership to withdraw their requests to permit a thorough, comprehensive review of the changed financial services industry and mortgage market circumstances that give rise to the multidistrict issue. That review has occurred without producing any compelling reason for the Finance Board to address the question of expanded multidistrict membership on its own initiative.

My commitment to those Banks that withdrew their pending regulatory requests, however, was that, when the review was complete, any Bank seeking authority to admit as a full member an institution doing business in that Bank's district but maintaining a charter and membership in another Federal Home Loan Bank district would be afforded an opportunity to make its case to the Finance Board and present its recommended solutions to the various operational challenges its proposal would raise. In June, in fulfillment of my commitment to those Banks, I requested the Office of Supervision and the Office of General Counsel to draft a proposed regulation establishing a process by which the Finance Board could receive, review, and accept or reject such applications, should any Bank choose to make one. No Bank, however, has made any request to the Finance Board to proceed on multidistrict membership, the draft proposal was never completed, and no further Finance Board action establishing a procedure is planned.

Conclusion

Chairman Bennett, distinguished Members of the Subcommittee, I close by returning to the very reason the Federal Housing Finance Board exists: to ensure that Federal Home Loan Banks operate in a financially safe and sound manner, carry out their housing-finance mission, and remain adequately capitalized and able to raise funds in the capital markets.

Since 2002, the Finance Board has dramatically improved its ability to perform these statutorily mandated responsibilities. The Agency's supervision function is stronger, more thorough, and more effective. Taken in conjunction with the initiative to enhance the financial disclosures filed by the Federal Home Loan Banks, I believe the Finance Board is capably representing the interests of the public and taxpayers who stand behind the Federal Home Loan Banks and who benefit from the successful performance of the Federal Home Loan Banks' important role in housing finance.

PREPARED STATEMENT OF NORMAN B. RICE

PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN BANK OF SEATTLE

SEPTEMBER 9, 2003

Good afternoon Chairman, Ranking Member Johnson, and Members of the Subcommittee. I am Norman B. Rice, President and Chief Executive Officer of the Federal Home Loan Bank of Seattle.

I would like to thank Chairman Bennett and the Subcommittee for the opportunity to provide my perspective on the unique and vital role the Federal Home Loan Banks play in building strong communities and healthy economies across America.

The 12 Federal Home Loan Banks have a long history of service and accountability to the more than 8,000 financial institutions we serve, to the millions of individuals and families we help realize the American Dream of homeownership, and to the regulators and Congress who oversee our system.

But it is not the history of our banks that I want to talk with you about this afternoon. Where we have been and what we have accomplished as a Bank System is significant and well documented. But my focus is on the relevance of the Bank System today—and in the future—and the critically important role we play on behalf of our financial institution members, and the economic health of our country.

I will start with what I consider to be the most important element of the Federal Home Loan Banks—we are a cooperative. Our members own the Bank System, and we are accountable to them.

We are truly unique in that sense. By constructing the Home Loan Banks as a cooperative, Congress ensured that all value and benefits from the System are passed directly back to the member financial institutions that are the lifeblood of small business, agriculture, and neighborhood revitalization in this country.

These are the banks, credit unions, thrifts, and other institutions that give communities critically needed access to credit; these are the risk-takers whose leadership and resources build stronger towns, cities, and, to a very real extent, a stronger Nation.

You can do that in a cooperative that provides each one of its members—small and large—the same access to a stable, low-cost, and reliable source of wholesale funding. In turn, you cannot do what we do in a publicly traded company where your primary focus is building investor value for tens of thousands of individual stockholders.

It works much differently in the Federal Home Loan Bank System. We have a business relationship with each of our members—they are both our owners and our customers. We know them by name. We understand their individual market needs and the needs of their communities. They are represented on our boards and provide the leadership of our 12 banks.

No other housing GSE or financial institution can replicate this partnership of bank, member, and community.

At the Seattle Bank, we like to use the term "rock solid" to characterize our organization and the business relationship we have with our members. It conveys a sense of accountability and commitment to our cooperative, and the unwavering belief that a member's investment is being managed for the long-term, not just quarter to quarter. That is how our member financial institutions see us—as a safe, sound partner they can use to more effectively manage their balance sheets—in good economic times and bad—for the purpose of better serving their local customers and communities.

Within the cooperative structure of the Bank System, it is also important to understand the profile of our membership. The overwhelming majority of our member financial institutions are smaller, community-based companies. Our typical member has about $110 million in assets, almost half of our members are located in rural areas, and most are independently owned.

We also serve the Nation's largest lenders. Our Congressionally mandated mission is to make bank credit available for our local communities. Given the realities of the financial services industry, which has consolidated enormously, it would simply be impossible to fulfill our mission unless we also supported the largest lenders who now account for a vast amount of lending activity. For example, the top three U.S. lenders now account for 37 percent of all home mortgage originations. The top 30 originators account for 60 percent of all loan originations.

As you can see, the Bank System cooperative is a place where financial institutions of all sizes share mutual interests and share mutually in the benefits of their joint enterprise.

As I sit before you today, the Federal Home Loan Banks and the housing GSE's are facing significant challenges and changes regarding their business practices, regulatory structure and mission-based programs and activities.

There is much to discuss and determine in the coming months, and potentially much at stake for financial institutions, businesses, homebuyers, and the American economy.

As this Subcommittee and other Members of Congress consider the future of the Federal Home Loan Banks and the housing GSE's, you will no doubt be inundated

with recommendations and solutions from many people representing many of the constituencies that have come before you today.

As a former public policymaker, I remember that process all too well. But in place of recommendations and solutions, I would like to offer you two things today: Some baseline questions and principles to consider in your discussions in the weeks and months ahead, and clear evidence of the powerful impact the Bank System has on our country's financial services industry, our communities, and our economy.

First, two questions that I believe appropriately frame the issues now before Congress regarding our Bank System and housing GSE's.

- What are the benefits and risks that the housing GSE's present to taxpayers?
- How are the risks best managed?

Over the course of any week in my job, I am asked by a number of people what the Federal Home Loan Bank of Seattle is, and what it does. For those not involved in the banking and financial services industry, our system is, for the most part, unknown. So, I am always pleased to provide some quick education, and pleased because of the answer I am able to give: We help ensure that Americans have homes and healthy local economies.

How do we do that? By connecting financial institutions of all sizes to the capital markets. This provides our member banks with a stable source of lower-cost funds that they use in their own communities to support homebuyers, businesses, and farmers.

But perhaps an even better way to illustrate the benefits of the Bank System is to imagine our country without the 12 Home Loan Banks. Consider the following:

- In 2002, the Bank System extended nearly a half trillion dollars in advances (what we call loans) to our member financial institutions, strengthening local economies, and increasing homeownership. *Imagine those dollars gone.*
- Since 1991, the Federal Home Loan Banks have awarded $1.6 billion in Affordable Housing Program grants, helping to create 360,000 low-income housing units across the country. Each of our 12 Banks annually provides 10 percent of their net income for affordable housing. Last year, that totaled about $200 million. *Imagine those dollars gone.*
- In 2002, the Bank System provided nearly $9 billion in reduced-rate, long-term Community Investment Program (CIP) advances, used by our member financial institutions to finance commercial and economic development initiatives that benefit low- to moderate-income families and neighborhoods. Since CIP began in 1990, our Banks have issued nearly $36 billion in reduced-rate loans. *Imagine those dollars gone.*

Now imagine the collective impact on our national economy, not to mention individual business owners, homebuyers, and farmers.

Ask yourselves who would provide the bank credit to support your local economies? How would your local bank compete if they did not have access, through their regional Home Loan Bank, to the capital markets? Where would these institutions turn, in good times and bad, to meet loan demand despite the outflow of consumer deposits from the banking system? Where would your constituents go to get loans to buy homes and run their businesses?

Now go one step further: If the housing GSE's did not exist today, what would Congress put in their place? I believe you would come back to something that looked a lot like the Federal Home Loan Bank System.

Here's why:

- *The Bank System is funded entirely through private capital.* The cooperative is built by private owners who have put more than $36 billion of their own money at risk to capitalize the Bank System.
- *The Bank System is cooperatively owned to support—rather than compete with—the private marketplace.* Our stock is not publicly traded. We are not driven by an imperative for double-digit growth to meet expectations of the stock market. We do not have third-party investors pulling value out. Every dollar of value created by the Bank System is poured back into the housing finance system, ultimately benefiting your constituents, the consumers of bank credit. Those are bank owners, business owners, farmers, homebuyers, nonprofit housing corporations, neighborhood social service organizations, municipalities, and many, many others.
- *The Bank System has the capacity to innovate and keep pace with an evolving financial services industry.* This is why the Bank System offers mortgage purchase programs. Our members have told us they can better serve homebuyers and local markets if there is more competition in the secondary mortgage markets. It is no accident that our System's program volume has accelerated from zero to almost $100 billion. Without question, there is a private-market demand for competition,

and we believe that competition is healthy—it is good public policy. And it is equally important to remember that when programs such as these boost earnings and profitability in our banks, that provides more funding for affordable housing and economic development in our communities. At the Seattle Bank last year alone, our Mortgage Purchase Program generated $1.75 million in additional AHP subsidies. My point here is, you cannot disconnect profitability and mission with the Bank System.

- The Bank System is organized by region, ensuring that each bank is connected and responsive to local markets. Twelve Home Loan Banks were created to focus on local markets, to know their local member financial institutions and create products and services that meet their customers' needs and the affordable housing and economic development needs of their communities.
- The Bank System pays its fair share of taxes. The Home Loan Banks carry a special tax burden that cannot be sheltered and is equivalent to a Federal corporate tax rate. The Bank System has been required, since 1989, to pay off the REFCORP debt and provide 10 percent of its net income in support of low-income housing. This is the single-largest private source of housing subsidy in the United States.
- *The Bank System is a reliable source of liquidity through all parts of the economic cycle.* This is the primary reason why financial institutions join the Bank System. They rely on our capacity to access the capital markets on their behalf. That is why, even in a down economy, demand for advances across all of our banks has reached nearly a half trillion dollars.

As you can see, it is not a difficult task for me to list the benefits provided by the Bank System. Over the last 70 years, the 12 Home Loan Banks have consistently proven their relevance to our members and their communities.

The harder question—especially in today's environment—is whether or not the risks are being managed appropriately. While it is one thing to say our advance and mortgage purchase programs drive profitability and support mission-based programs and activities—which they do—it is quite another to ensure that the risks inherent in those programs are being managed appropriately.

My colleagues testifying on this panel today will address other key issues regarding the Bank System, including risks associated with financial management, governance, and regulatory oversight.

Just as I have noted some attributes and principles that should underlie a modern housing GSE, I would like to also articulate some basic principles as you consider GSE oversight going forward.

First of all, it would be disingenuous of me or anyone else to state that the Home Loans Banks and other housing GSE's are far bigger and more complex, and therefore should be held to different risk standards. Clearly, the bar has been raised across the financial services industry in this regard.

While history proves that we have done a great job for a long time—not a single credit loss against advances since the inception of the Bank System in 1932—I also understand this is 2003, not 1932, and much more must be done. Your constituents and ours are demanding the highest levels of accountability, and we must deliver on that.

On the matter of consolidation of the GSE regulators: Whether or not Congress determines that a single GSE regulator is the appropriate direction or not, all three housing GSE's must have strong regulatory oversight to ensure both safety and soundness and mission achievement. There can be no debate on that point.

The fact is that the three housing GSE's must manage many of the same risks, and we share a common mission—to support homeownership by providing the funding and the tools the Nation's housing lenders need to be successful. That means it is time to straighten out the hodgepodge of inconsistent requirements and oversight of the housing GSE's.

For example, why do two housing GSE's have lower capital requirements than the Home Loan Banks that demonstrably carry less credit risk? Why is there inconsistent mission oversight—with the Home Loan Banks delivering cash grants, while the other housing GSE's hit a different set of affordable housing goals?

What public policy goal is advanced when roadblocks are put in front of our Bank System when we respond to our members' stated desire to have greater competition in the secondary mortgage market? And when, in fact, those roadblocks actually hinder our ability to drive more funding to our member financial institutions and their communities? I have heard it called "mission creep." From my point of view, it is more like "mission leap"—it allows us to take more significant steps toward fulfilling our mission, not walking away from it.

While it is often frustrating to me that the Bank System's mission and impact is understood by so few, I think it is apparent that this Nation and your constituencies—our financial institutions and local communities—would struggle mightily if we failed to do our job.

Today, as one of 12 presidents within the Federal Home Loan Bank System, I stand committed to work with you to find better ways to serve the ever-changing needs of the financial services industry and our communities.

I want to be clear that I believe the onus for strengthening our system lies not only with Congress and regulators, but with the Home Loan Banks themselves. We must further step up and accept the risks in our system and industry, and accept that more intense public oversight is inevitable. We welcome that public oversight because, if done smartly, it will strengthen our Bank System and, ultimately, the economy of this country.

In closing, I would like to leave you with some principles that I believe should inform your discussions and decisions in the months to come:

- Private capital is the most effective cushion to guard the public against the risks inherent in our enterprises. As cooperatives, the Home Loan Banks are capitalized by their customers, who are risk-averse, and who monitor risk-taking in a way that third-party shareholders cannot.
- Insist on competition among housing GSE's rather than competition with the private financial services industry.
- Demand that more of the value created by the housing GSE's be delivered to the housing finance system and consumers rather than private investors.
- Demand consistent, strong and smart regulatory oversight for all housing GSE's—and recognize the critical differences between the Bank System and publicly traded housing GSE's.
- Demand an intense focus on our mission, hold us accountable, and keep in mind what America would look like if the Home Loan Banks did not exist.

Mr. Chairman, this concludes my written remarks. Thank you, again, for allowing me the opportunity to speak with you today. I would be happy to answer any questions you or other Members of the Subcommittee may have.

PREPARED STATEMENT OF MICHAEL MIDDLETON

VICE-CHAIRMAN, FEDERAL HOME LOAN BANK ATLANTA

CHAIRMAN AND CEO, COMMUNITY BANK OF TRI-COUNTY, WALDORF, MD

SEPTEMBER 9, 2003

Good afternoon Chairman Bennett, Senator Johnson, and Members of the Subcommittee. Thank you for the opportunity to appear before you today to discuss something that is very important to my business and to my community—the Federal Home Loan Bank System. I am Michael Middleton, Chairman and CEO of Community Bank of Tri-County, in Waldorf, Maryland. I serve as Maryland's elected Director on the Federal Home Loan Bank of Atlanta's Board of Directors and am honored to serve as the Vice-Chairman of that Board. I am also a Member of the Board of the Council of Federal Home Loan Banks.

I am pleased to testify today on behalf of the Atlanta Bank. I am Chairman and CEO of a bank that is a member and long-time user of Federal Home Loan Bank advances, as well as other products, particularly in the community investment area. I believe this experience, together with my 5 years of service on the board of the Federal Home Loan Bank of Atlanta, gives me a broad perspective on the Federal Home Loan Bank System that I hope can provide helpful insight to the Subcommittee.

Community Bank of Tri-County has over $300 million in assets and is a true community bank serving southern Maryland. Our customer base draws from a broad economic range and includes rural, agricultural, small business owners, and the families employed by high tech companies that support three naval facilities. We try to tailor our services and products to meet the needs of our communities while competing with large regional and national financial institutions.

At my bank, we take our Community Reinvestment Act responsibilities very seriously. Moderate to smaller-sized community banks are increasingly challenged in meeting their CRA requirements. The FHLBank's programs, explained in greater detail below, provide us with the tools and skills to fulfill this statutory and community responsibility. The FHLBank System helps level the competitive playing field

in many ways, enabling Community Bank to continue to be part of the economic foundation of southern Maryland.

Background

As you may be aware, the 12 Federal Home Loan Banks are Government Sponsored Enterprises that were created and organized under the authority of the Federal Home Loan Bank Act of 1932. Congress created the Federal Home Loan Banks to stabilize and improve the availability of funds to support homeownership. Although initially capitalized with Government funds, member banks, like mine, have contributed all the Federal Home Loan Banks' capital for over 50 years. The Federal Home Loan Banks have provided over 70 years of innovation and service to the U.S. housing market, and currently have over 8,000 member institutions.

The Federal Home Loan Banks and their members (federally insured savings associations, commercial banks, credit unions, and some insurance companies) are the largest source of residential mortgage and community development credit in the United States. Federal Home Loan Banks increase the lending power of local financial institutions. Thanks in large part to the work of Senators Hagel, Johnson, and Bayh to include Federal Home Loan Bank modernization in the Gramm-Leach-Bliley Act, the Federal Home Loan Banks help community financial institutions provide critical small business, community development, rural and agricultural loans, as well as residential mortgages. I believe it is important to note, Senators, that the Federal Home Loan Bank System is the only institution in the United States that fulfills this mission.

The Federal Home Loan Banks are very different from the other housing GSE's. They are unique in that they are cooperatives that are jointly and severally liable for the consolidated debt issued through the Office of Finance as their agent. As cooperatives, only member institutions own the capital of each Federal Home Loan Bank. There is no publicly traded stock and no established marketplace for the Federal Home Loan Banks' capital. Further, there is no market pressure on the price of the capital stock; it is always bought and sold at par. While the Federal Home Loan Banks are not the only cooperatives, nor are they the only institutions that operate with joint-and-several liability, no other housing GSE or private sector financial institution plays the same economic role or operates under the same overall structure as the Federal Home Loan Banks.

It is the task of the Federal Home Loan Banks to maintain a balance between their public policy mission and their obligation to provide adequate returns on the capital supplied by their members. They do this by providing a stable, low-cost, and reliable source of short- and long-term funding. For many Federal Home Loan Bank members that are small- or medium-sized community banks, direct borrowing in the capital markets is not a viable option. With the disintermediation of our deposits to Wall Street during the 1990's, a gap in funding during the last economic expansion proved the value of the FHLBanks in assisting us in meeting the credit needs of our local market. By providing a necessary source of wholesale funding to help members manage liquidity, loan demand, and interest rate risk, the Federal Home Loan Banks enable us to remain independent and continue as an economic engine in our community. Between 1994 and 1999, approximately 30 percent of all wholesale funding used by banks came from the Federal Home Loan Bank System.

As regional institutions, each Federal Home Loan Bank develops its programs in response to the needs of its membership. For example, in response to member demand, the Federal Home Loan Bank of Atlanta provides its members a competitive alternative to the traditional residential secondary mortgage market through two acquired member asset (AMA) programs, Mortgage Partnership Finance,® and Mortgage Purchase Program. These AMA programs provide medium- and smaller-sized institutions with another financial tool in delivering competitive credit products. Like the advance programs, the AMA programs help level the competitive playing field.

Reflecting the Federal Home Loan Banks' cooperative nature, the financial strategies of the Federal Home Loan Banks are designed to enable them to expand and contract in response to their members' credit needs.

Federal Home Loan Bank Programs—How They Meet Their Mission Locally

My bank relies on the Federal Home Loan Bank of Atlanta and its programs to deliver financial services to our communities. Like much of the country, our area needs more affordable housing. The price of housing continues to rise and demands for land limit the availability of workforce housing throughout our local market. Our major population centers are growing, resulting in greater need for improved medical, school, and volunteer fire/rescue support facilities. The Federal Home Loan Banks are often an invisible, but vital, partner in fulfilling these needs. We use the

FHLBank to provide the critical first layer of support upon which many layers of private and public support are built to bring about new affordable housing and/or community growth.

Community Bank has partnered with a number of nonprofit Community Development Corporations to support affordable housing and infrastructure development projects through programs offered by the Federal Home Loan Bank of Atlanta. These include the Affordable Housing Program (AHP) and the Economic Development and Growth Enhancement (EDGE) Program. By using AHP, EDGE, and other similar programs, community banks like mine can make affordable housing and community development projects economically feasible.

A good example of this is the Yardley Hills project in Calvert County, Maryland. That project utilized over $2.7 million in complex layered funding made available by participation in the Federal Home Loan Bank of Atlanta's Affordable Housing Program. In another project, we used the EDGE loan program to provide the Jarboe Family Head Start Center in St. Mary's County, Maryland with permanent funding when other traditional banking sources of large regional banks became unavailable.

Federal Home Loan Bank Community Investment Programs have allowed us to partner with the USDA to provide single-family homeownership to very low-income families with structured funding and first time homebuyer funds.

Finally, for one of our community's volunteer fire/rescue needs, we obtained a $2,000,000 Economic Development Program advance to provide permanent financing for a new firehouse located in a low-income community in La Plata, Maryland.

Senators, these projects and hundreds of others like them would not have been economically feasible without the programs of the Federal Home Loan Bank. They enable community banks to meet those credit needs that often would go unmet by larger nonlocal banks. It is also important to point out that the Federal Home Loan Banks provide the training and technical assistance that teach smaller institutions to use these programs—training that would otherwise be too expensive for or unavailable to community banks.

The examples I have given with respect to my bank describe in part the distinctive role played by the Federal Home Loan Banks in housing finance. They make loans, called advances, to their members on the security of mortgages and other eligible collateral. Federal Home Loan Bank advances directly support our housing markets, including those focused on low- and moderate-income households, as well as all aspects of community development critical to the creation of jobs.

Federal Home Loan Banks also help their members provide other needed forms of community development credit. Since the passage of the Gramm-Leach-Bliley Act, Federal Home Loan Banks may now allow "community financial institutions" to pledge as collateral for advances small business, small farm, and small agribusiness loans. Expanding the types of eligible collateral that smaller financial institutions may pledge serves a number of purposes. Many smaller institutions, particularly in rural areas, have faced funding needs but have not had sufficient residential mortgage collateral to secure FHLBank advances. Expanding the eligible forms of collateral for these institutions will help them meet these funding needs. With the help of the Federal Home Loan Banks, small local financial institutions may now better serve the community development credit needs of their areas.

As I indicated earlier in my testimony, the Federal Home Loan Banks also help members meet their Community Reinvestment Act (CRA) responsibilities. They do this through programs such as the Affordable Housing Program (AHP), the Community Investment Program (CIP), EDGE, and others. These programs give members access to subsidized and other low-cost funding for affordable housing and community development projects that benefit low- and moderate-income neighborhoods.

By supporting their member institutions, the Federal Home Loan Banks also strengthen their communities. Each Federal Home Loan Bank is required, by law, to allocate 10 percent of its net income to affordable housing programs. The funds provided under this program are grants and loans. Last year, the Federal Home Loan Banks contributed $199 million to the AHP. Since the program's beginning in 1990, the Federal Home Loan Banks have set aside approximately $1.7 billion in AHP subsidies, helping to create 360,000 units for low-income families. The Federal Home Loan Banks collectively are the largest source in the Nation of private funding for affordable housing.

The Federal Home Loan Banks also have established a number of other housing and economic development initiatives for their members. These programs are funded voluntarily by the Federal Home Loan Banks separate from AHP. The Federal Home Loan Bank of Atlanta has established a predevelopment fund that offers recoverable grants to help finance predevelopment expenses associated with affordable housing and economic development projects. The Atlanta Bank also offers a training and technical assistance initiative for community development corporations serving

the neighborhoods surrounding Historically Black Colleges and Universities, as well as a subsidized loan program called EDGE, mentioned earlier in this testimony, to finance targeted community economic development projects. In addition, FHLBank Atlanta also offers both an at-cost advance program to help members finance loans for economic development activity, and a fund to provide matching equity investments for members investing in New Market Tax Credits.

In addition to examples cited earlier involving my bank, EDGE loans have helped finance a childcare center serving low-income families in Tuscaloosa, Alabama. Training and technical assistance supported by the Federal Home Loan Bank of Atlanta in North Carolina enabled Elizabeth City State University, a Historically Black University, to obtain financing through the Bank's Affordable Housing Program for the rehabilitation of owner-occupied units damaged by Hurricane Floyd. Other Federal Home Loan Banks have customized programs as well—programs like assistance to potential minority-homebuyers; first-time low-income homebuyer programs; various predevelopment and affordable housing capacity initiatives; flood relief assistance programs; and rural technical assistance programs to help communities address unmet affordable housing needs by establishing rural housing partnerships.

I strongly believe that the Federal Home Loan Bank System is able to provide the important benefits it does because of its dynamic membership of large and small institutions and its regional, decentralized, cooperative structure. And, I can say unequivocally that without the Federal Home Loan Banks and the programs they provide, it would be far more difficult for my bank, and the thousands of other community banks to remain independent, competitive, and capable of extending important housing and community development credit.

FHLBank and Director Responsibility

I have discussed the role of the Federal Home Loan Banks in meeting their mission of providing competitive funding to their member financial institutions to increase the availability of funds for residential and community development lending. I have given you examples of why the Federal Home Loan Bank System is so vital for community banks like mine. As I stated earlier, I am also an elected Member of the Board of Directors of the Federal Home Loan Bank of Atlanta, and that role imposes additional important responsibilities.

As a director, I know that the Federal Home Loan Banks have obligations in addition to the mission of being a creative funding source for the extension of residential and community development credit. The Federal Home Loan Banks, although being exempt from Federal, State, and local taxation, are required to make payments to the Resolution Funding Corporation (REFCORP) and the Affordable Housing program (AHP). Those mandatory contributions are equivalent to a 26.5 percent effective income tax rate.

The Federal Home Loan Bank of Atlanta and its board of directors support the Administration's position that the housing GSE's should provide complete and transparent financial disclosures that constitute "best of class." That is why we, along with the other FHLBanks, have been working on these issues with all relevant parties to resolve the specific issues presented by the FHLBanks' statutory mission, cooperative structure, and joint and several liability.

As a director, I want the Atlanta Bank to meet the highest standards of disclosure. At the same time, as a director, I have an obligation to all the other member/owners to be certain that such disclosures are not administered in a manner that could impair the mission, operations, or increase the cost of funds of the Bank. If, as a director, I agree to voluntarily register the Bank's equity with the SEC, not only do I assume additional personal civil and criminal liabilities under the relevant statutes, but I also assume liability for my decision to voluntarily register. In conducting my fiduciary duty as a corporate director consistent with the Business Judgment Rule, I must believe that all critical issues have been satisfactorily resolved and sustainable agreements reached before I, as a director representing the shareholders of the Bank, am permitted to agree to such action.

Just one example of the outstanding issues is how joint and several liability will be handled. The Federal Home Loan Banks have always been jointly and severally liable for each other's debt. Under SEC registration, it is possible that each Federal Home Loan Bank could have to create an additional on balance sheet liability reflecting the "fair value" of such liability for the combined debt of all the FHLBanks. Critical accounting issues like this and others must be effectively resolved in a manner that all the Federal Home Loan Banks can rely on going forward without the threat of quarter-to-quarter or year-to-year reconsideration upon each SEC filing.

Contrary to popular misconceptions, the Federal Home Loan Banks are privately capitalized by their members and do not receive any taxpayer assistance to operate.

The Federal Home Loan Bank System debt is not guaranteed by the Federal Government, and does not constitute an obligation of the United States. The Federal Home Loan Banks have operated since 1932 to help bring needed credit to the members and communities they serve. And they have done so in a safe and sound manner. The Federal Home Loan Banks are required by statute to obtain sufficient collateral on advances to protect against losses, and to accept only certain collateral on their advances. Consequently, no Federal Home Loan Bank has ever experienced a credit loss on an advance. At the end of 2002, for example, the Federal Home Loan Banks had rights to collateral, either loans or securities, on a member-by-member basis, with an estimated fair market value in excess of outstanding advances.

The resources and services provided by the Federal Home Loan Banks to their member institutions play a key role in the continued success of our Nation's housing market. They play a key role in serving the financial needs of our local communities. Without the Federal Home Loan Banks, it would be far more difficult for our Nation to achieve these objectives.

Thank you for the opportunity to appear before you this afternoon. I would be pleased to answer any questions that you may have.

PREPARED STATEMENT OF SHEILA C. BAIR

DEAN'S PROFESSOR OF FINANCIAL REGULATORY POLICY
ISENBERG SCHOOL OF MANAGEMENT, UNIVERSITY OF MASSACHUSETTS

SEPTEMBER 9, 2003

Chairman Bennett, Senator Johnson, Members of the Subcommittee, it is a pleasure to appear before you today to assist you in your oversight of the Federal Home Loan Bank System. A strong housing market is among the Nation's top economic priorities, and the Federal Home Loan Bank System is an indispensable component of that market. When the Hoover Administration developed the blueprint for the System in the throes of the Great Depression, it was based on the premise that this cooperative was needed to assure a constant flow of funding when deposits proved inadequate due to national or regional economic conditions. Seventy years later, with over $500 billion in FHLB advances outstanding, the underlying premise for the System remains valid. The Federal Home Loan Banks play a vital role in mortgage finance and deserve to be continued and strengthened.

Challenges Confronting the System

It is in the spirit of System supporter that I come to you this morning to raise three issues that I believe warrant your attention: Multidistrict membership, expansion of the System's mortgage acquisition programs, and lack of SEC registration of FHLB securities. These issues are important because their resolution will help determine the future of the system and its long-term stability. They were examined in detail in a paper I recently completed that was funded by a grant to the School of Management from the Fannie Mae Corporation, which I would like to submit for the record. The conclusions reached in the paper are my own, and do not reflect the views of the research sponsor. After discussing my paper, I will make some general observations about the FHLB System's regulatory structure in relation to efforts underway to improve safety and soundness regulation of Fannie Mae and Freddie Mac.

Multidistrict Membership

Recent industry consolidations have prompted some to call for allowing members to belong to more than one district FHLBank. Throughout the System's history, no single institution has ever been a member of more than one district bank and the System's authorizing statute leaves little doubt that this is what Congress intended. The Federal Housing Finance Board's (FHFB) efforts to allow multidistrict membership by regulation have been highly controversial, supported by only 5 of the System's 12 district banks. Four of the FHLBanks are strongly opposed, with the remaining three undecided and expressing serious reservations.

My primary objection to multidistrict membership is that Congress—not the FHFB—should decide whether such a fundamental change should be made to the System's historic regional and cooperative structure. I am also concerned that multidistrict membership could have a destabilizing influence on the System. Multidistrict membership would allow large institutions to "shop" their advance activity among multiple FHLBanks, but because all the FHLBanks raise funds in the same way, their ability to compete based on price will be limited. As a consequence, they will likely compete on collateral and credit standards. In addition to diminution of credit quality, allowing one member to have multiple relationships with FHLBanks

would increase operational risk since the System lacks safeguards to obviate the multiple pledging of collateral or the prospect of competing blanket liens. Moreover, allowing multiple memberships could increase large borrower activity in the System as a whole, thus exacerbating large borrower concentrations. Nearly 24 percent of all advance activity is already concentrated in the System's 10 top borrowers.

Multidistrict membership would, by definition, help only institutions large enough to take advantage of it, and fundamentally alter the basic concept of the System—a cooperative of regional banks existing to serve the funding needs of institutions headquartered in their districts. Moreover, given the seismic consolidation activity that occurred in the 1980's—which the System weathered quite well—it is difficult to see why current consolidation activity should provide the impetus for such a dramatic restructuring. Under a holding company structure, separately chartered subsidiaries have been able to hold memberships in different banks—the same arrangement commercial banks have with the Federal Reserve Banks—which maintains consistency with the Federal Home Loan Bank Act and the regional character of the System.

The Mortgage Acquisition Programs

The second issue I examined—expansion of the System's mortgage acquisition programs—also primarily benefits the System's largest members. Begun in 1997 as a small pilot capped at $750 million, these programs have grown exponentially. The System now holds $90 billion worth of mortgages in portfolio, representing over 10 percent of its assets. One FHLBank now has half its assets invested in mortgages and only one-third of its assets in advances, the business activity that Congress assigned it.

There is nothing in the System's legislative history or authorizing statute that grants authority for direct mortgage purchases, and the other two major housing GSE's, that is, Fannie Mae and Freddie Mac were established and chartered by Congress expressly for that purpose. Congress, not the individual FHLBanks or the FHFB, should decide whether it wants the System to be a major player in the secondary mortgage market, and if so, the terms and limitations that should apply.[1]

The risks associated with mortgage acquisition are distinctly different from those associated with the System's traditional role of making fully collateralized advances. Advances have prepayment penalties and call features that allow the FHLBanks to effectively manage their interest rate risks. Different, more complex tools are needed for the interest rate/prepayment risk presented by mortgages held in portfolio. Operational risk is also significant—there is a serious question as to whether the System has sufficient numbers of qualified staff or infrastructure needed to manage even the day-to-day risk associated with secondary mortgage market participation. The staffs of each FHLBank and the Office of Finance are relatively small, and they are trained in the traditional business of advances, not mortgage acquisition and portfolio management. Regarding credit risk, the mortgage acquisition programs' proponents boast that the originators—not the FHLBanks—retain the credit risk. In truth, the originators provide credit enhancements that are only as good as the FHLBanks require them to be based on their own interpretation of historical default data, which again, is outside their traditional mission and expertise. It is also telling that a recent FHFB proposed rulemaking—now withdrawn—would have eliminated one of these programs most important tools in managing credit risk—the requirement that pools of purchased mortgage assets achieve an investment grade rating from an independent ratings agency.

No adequate public policy basis has been advanced for the System's foray into this new, riskier line of business. Though promotional materials for the programs claim that they are designed to help smaller institutions, available data suggests that they are being run overwhelmingly for the benefit of large originators. According to trade journal reports, the top five mortgage originators sold $42.7 billion in mortgages to the FHLBanks in 2002.[2] Assuming the accuracy of this report, these five institutions would account for almost all of the $45.7 billion dollars in FHLBank mortgage acquisitions in 2002. If Congress wishes to authorize yet another GSE entry into the secondary mortgage market, it should assure itself there is a valid public policy basis to do so. Meeting legitimate market needs of smaller, community-based institutions might be one justification. Enriching large mortgage originators is not.

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[1] Congress placed specific limitations on Fannie Mae and Freddie Mac regarding capital, safety and soundness, and mission requirements. However, since Congress never authorized the FHLB System to enter the secondary mortgage market, it did not specify the limitations that should apply.

[2] Inside the GSE's (April 2, 2003), at p.6; 2002 FHLBank System Annual Report at p.22.

SEC Registration

In my paper, I also concluded that voluntary SEC registration would be in the best interests of the System and its debtholders. I will not belabor the arguments, because Assistant Secretary Abernathy has already eloquently stated them in his testimony. Suffice it to say, voluntary SEC registration would enhance the image of the System and demonstrate that the FHLBanks are committed to a policy of full disclosure.

Thoughts on Regulatory Structure

Questions about the capability of the System to manage new risks associated with multidistrict membership and mortgage acquisition programs are heightened by longstanding weaknesses in the FHFB examination process, identified by the Government Accounting Office (GAO) in 1998 and again in 2002. Though the FHFB has taken a number of steps to address these weaknesses, including increasing the number of examiners and putting greater focus on major risks and the quality of controls at FHLBanks, the GAO found in a report released last February that it is still too soon to evaluate the effectiveness of these measures. As of February 2003, the FHFB had only 14 examiners, with plans to increase the total number of examiners to 24 by the end of 2004. According to its fiscal year 2003 budget, only $9.7 million of its $27 million budget was allocated for the Office of Supervision. By way of comparison, Treasury's two bank regulatory bureaus—the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) will typically assign teams of 20–30 examiners to *each* of its largest institutions, and will spend 70–80 percent of their budgets in direct support of supervision.

More fundamentally, the structure of the FHFB suffers from many of the same defects now being scrutinized at the Office of Federal Housing Enterprise Oversight. It is a small, low-profile agency that simply cannot attract and retain the quality of staff that it needs. It exists outside the financial regulatory mainstream, and thus does not benefit from the, routine day-to-day interaction that occurs among the major bank regulatory agencies. It is responsible for only 12 Banks, plus the Office of Finance—a narrow constituent base that creates the perception of "captive regulator." Other major financial regulators have a much broader regulatory base, and their actions are generally reflective of the views and interests of diverse and competing constituencies. For instance, bank regulators are constantly mediating differences between large and small banks, those with different business lines, geographic concentrations, or customer bases. This in turn enhances the credibility and quality of regulatory decisionmaking. When a regulator's jurisdiction is confined to a small group of closely aligned institutions, the pressure and input it receives can become narrowly focused and one-sided. It becomes difficult for the regulator to stay objective and "above the fray."

Should a new agency be created at the Treasury Department for oversight of Fannie Mae and Freddie Mac, I believe it would be a stronger agency if it also included oversight of the FHLB System. The new regulator would have a bigger, better view of the housing finance market and would be in a better position to evaluate the advantages—and dangers—of the major housing GSE's competing directly with each other in the same lines of business. From the standpoint of systemic risk and taxpayer exposure, it is just as important to the Government for the FHLB System to have quality safety and soundness oversight as it is for Fannie and Freddie. At year-end 2002, the System had $668 billion in outstanding debt, compared to Fannie's $884 billion and Freddie's $644 billion. It enjoys the same implied government guarantee, with an even more generous line of credit from the U.S. Treasury. Though unlikely, a widespread failure in the System could have staggering ramifications for U.S. taxpayers and the housing market.

Some have argued that the FHLBanks would be overwhelmed by the other two politically powerful GSE's if their oversight were to be housed in the same agency. I do not believe it. With their longstanding community bank ties, and extensive grass roots, I have no doubt the FHLBanks can hold their own. I have also heard it argued that the Treasury Department would be hostile to the System, which I can say from first hand experience is not the case. On the contrary, I believe the Treasury respects the role of the System in the housing finance market and would not do anything to disrupt it.

The competitive impact on FHLB funding costs should also be weighed in the balance when considering whether to merge the FHFB into the new agency. The creation of a credible, high quality GSE regulator within the Treasury will likely receive a positive reaction in the capital markets, which could reduce Fannie and Freddie's funding costs. If the FHLB System is left out, that could widen spreads between FHLBank securities and those issued by the Enterprises. Wider spreads

would in turn mean a higher cost of funds for the FHLBanks, which would adversely impact the price of advances and other FHLBank services.

Conclusion

Strong momentum is building for the creation of a credible, high quality regulator within the Treasury Department to replace OFHEO. Now would be a propitious time for the Congress to consider whether oversight of the FHLB System should also be placed under this new regulator. To be sure there are important policy determinations that Congress needs to make regarding the FHLB System's mission and future, and it is important not to impede the momentum behind the transfer of OFHEO's safety and soundness functions. However, concurrent action could assure quality regulation of all three major housing GSE's, and prevent a widening of spreads, which could further weaken the System.

Thank you Mr. Chairman. I will now be happy to answer any questions you may have.

PREPARED STATEMENT OF TERRY SMITH

PRESIDENT AND CEO, FEDERAL HOME LOAN BANK OF DALLAS

SEPTEMBER 9, 2003

Mr. Chairman, Ranking Member Johnson, and Members of the Subcommittee, I appreciate the opportunity to speak to you today about the Federal Home Loan Banks. My name is Terry Smith, and I am President and CEO of the Federal Home Loan Bank of Dallas. I am also the current Chairman of the Bank Presidents Conference of the Federal Home Loan Banks (FHLBanks). Along with my colleagues, I am pleased to provide an update on the FHLBanks' activities and our progress implementing the FHLBank provisions of the Gramm-Leach-Bliley Act (GLB Act).

Overview of the FHLBanks

The FHLBanks were created in 1932 to support America's housing finance system. It was largely the FHLBanks' ability to raise long-term debt in the capital markets and pass that funding along to their member financial institutions that encouraged the development of the 30-year fixed-rate mortgage that is the predominant financing tool in the U.S. mortgage finance system today.

The FHLBanks continue to play a vital role in the Nation's housing finance and community lending system. Our member institutions, primarily community banks and thrifts, use the FHLBanks' advances program to meet the mortgage and community lending needs of their local markets, and use our Affordable Housing Programs to make housing more affordable for thousands of low-income families in those communities. These are our primary purposes, and we are proud of our accomplishments in carrying them out.

The FHLBank System, as it is sometimes called, is comprised of 12 individual FHLBanks, their 8,080 member institutions, and the Office of Finance which issues debt on behalf of the FHLBanks. Each FHLBank is a separate and distinct corporate entity with its own stockholder/member institutions and its own board of directors. While the FHLBanks issue debt collectively and are jointly and severally liable for the repayment of those debt obligations, there is no single controlling corporate entity with responsibility for or authority over the FHLBanks. The 12 FHLBanks operate independently under the authority granted by Congress through the Federal Home Loan Bank Act (Bank Act), as amended, and in accordance with the regulations established by and under the regulatory oversight of the Federal Housing Finance Board (Finance Board).

The FHLBanks are cooperative institutions that operate within districts originally established by the Federal Home Loan Bank Board, the predecessor to the Finance Board. Each FHLBank's capital stock is owned only by its member institutions, and only a FHLBank's members (plus certain nonmember housing associates such as state housing authorities) may conduct business with an individual FHLBank.

FHLBank members must meet certain statutory eligibility criteria. Each member must purchase the FHLBank's capital stock in order to become a member, and must maintain capital stock holdings sufficient to support its business activity with the FHLBank, either in accordance with the statutory formula or, for FHLBanks that have already implemented the capital plans required by the GLB Act, in accordance with the individual FHLBank's capital plan.

A FHLBank's capital stock cannot be issued to or held individually by members of a FHLBank's board of directors, its management, its employees or the public, and is not publicly traded. There is no market for FHLBank capital stock other than

among FHLBank members. The price of a FHLBank's capital stock cannot fluctuate, and all FHLBank capital stock must be purchased, repurchased, or transferred only at its par value. There are no stock options or other forms of stock-based compensation for FHLBank management, directors, or employees.

Prior to the passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, the FHLBanks' membership was generally limited to thrift institutions (building and loan associations, savings and loan associations, savings banks, homestead associations, etc.) and a handful of insurance companies. FIRREA expanded eligibility for membership to include commercial banks and credit unions with a demonstrated commitment to housing finance. The GLB Act further refined FHLBank membership rules by making federally chartered thrifts voluntary members for the first time and eliminating the remaining statutory differences in the terms of access between thrift institutions and commercial banks and credit unions.

The combination of the FIRREA and GLB Act statutory changes, along with changes in the mortgage lending market, have caused FHLBank membership to expand exponentially in the last decade. As of June 30, 2003, the 12 FHLBanks had a total of 8,080 member institutions, which included 6,037 commercial banks, 1,273 thrift institutions, 693 credit unions, and 77 insurance companies.

As an indication of the role the FHLBanks play in today's financial system, the FHLBanks' 7,310 commercial bank and thrift institution members represent approximately 79 percent of all FDIC-insured institutions in the country. Reflecting the structure of the depository institutions industry, approximately 6,519 (or 89 percent) of those FDIC-insured members are Community Financial Institutions (CFI's), as defined by the GLB Act. (CFI's are FDIC-insured institutions with average total assets for the 3 years ended December 31, 2002 of $538 million or less.) Altogether, approximately 7,493 member institutions (93 percent of all members) as of June 30, 2003 were community lenders with total assets less than $1.0 billion.

As noted previously, every member institution has made a voluntary decision to belong to a FHLBank. Among other things, that means that the FHLBanks must offer, and continue to provide, a membership value proposition that members perceive as adding value to their institutions. The value the FHLBanks provide our members is a blend of the modest dividends we pay on members' capital stock investment, the value of access to stand-by liquidity from the FHLBanks, availability of short- and long-term funds at attractive rates, and access to other products that make a community lending institution better able to profitably serve the credit needs of its community.

The FHLBanks' primary product offerings include traditional advances (fully secured loans to member institutions) and the more recently introduced Acquired Member Asset (AMA) programs. Advances represent the core of the FHLBanks' business, providing a source of funds members can use to support mortgage lending and, for CFI's, other community banking assets. The AMA programs, through which the FHLBanks acquire mortgage loans originated by member institutions under risk-sharing rules and other parameters established by Finance Board regulations, provide a secondary market alternative for those loans. In addition, the FHLBanks offer favorably priced advances for members' special community lending activities under their Community Investment Cash Advances (CICA) programs, and competitive grant programs that provide funds for housing for low-income families under Affordable Housing Programs (AHP) established following FIRREA.

Implementation of Gramm-Leach-Bliley Legislative Changes

Since the enactment of the GLB Act in November 1999, a principal focus of the FHLBanks has been the implementation of the FHLBank provisions contained in Title VI of that Act. The modifications to the Bank Act made by the GLB Act represented the culmination of many years of effort to reform the FHLBanks, particularly the membership rules and capital structure. The main purposes of the FHLBank provisions were to establish a system of universal voluntary membership, provide for a more permanent capital structure to accommodate voluntary membership, equalize the terms of access to the FHLBanks for all types of institutions eligible for membership, and to expand the types of collateral that community banks can pledge to secure advances. I am pleased to report that the FHLBanks are in the last stages of implementing those changes and fulfilling that purpose.

Before FIRREA, the membership of the FHLBanks was comprised almost entirely of thrifts that were required to be members by terms of their charter or deposit insurance. FIRREA authorized commercial banks to become voluntary members, but most thrifts continued as mandatory members. In addition, the terms of access to the FHLBanks for newly eligible institutions, including capital stock purchase requirements, differed from the requirements for thrift institutions. It quickly became

evident that this disparate treatment was inconsistent with the cooperative structure of the FHLBanks and was not needed to ensure that thrift institution members had adequate access to the FHLBanks. As a result, the FHLBanks and their members urged Congress to amend the Bank Act to provide for universal voluntary membership and equal terms of access.

The System of total voluntary membership has been successfully implemented. All members now have the same rights to access FHLBank products and services. In particular, the higher capital stock purchase requirements for advances to commercial banks and credit unions based on their different asset mix have been eliminated, which has enabled community bank members better access to advances and, in turn, to better serve the credit needs of their customers. And, although FHLBank membership is now voluntary for all, only a handful of institutions whose business model did not benefit from FHLBank membership have taken the opportunity to withdraw from membership.

Community banks historically have had a somewhat different customer base than thrift institutions, often spreading their lending activity among the various types of loans needed in the community, such as mortgage, small business, and small farm loans. In recognition of this fact and in order to allow the FHLBanks to better serve their members' needs, the GLB Act authorized the FHLBanks to make advances to CFI's secured by small business and small farm loan collateral. The FHLBanks have successfully and responsibly implemented this new authority, acting prudently as secured lenders to assign appropriate lending values to the new collateral and maintain their record of never having suffered a credit loss on an advance to a member. As a result, the new collateral authority has enabled community bank members to better serve their communities.

In order to implement universal voluntary membership, while at the same time providing for capital with more permanence, the GLB Act outlined a new capital structure for the FHLBanks. The major differences include authorization to issue two classes of capital stock—Class A stock redeemable with 6 months notice and Class B stock redeemable with 5 years notice—and implementation of new leverage, risk-based and total capital requirements. This new framework adds permanence to the FHLBanks' capital structure by requiring them to maintain sufficient Class B stock plus retained earnings to meet the new risk-based capital requirements.

The GLB Act created a series of statutory deadlines for adoption of new capital regulations by the Finance Board and adoption and implementation of new capital plans by the individual FHLBanks. All of the relevant deadlines have been met and the FHLBanks are well on their way to implementing their new capital plans. In fact, six FHLBanks have already implemented their new capital plans, I believe another FHLBank will implement its plan later this year, and the remaining five FHLBanks will implement their plans by mid-2005. Each FHLBank has developed its capital plan in consultation with its members and in accordance with the Finance Board's regulations. The plans have been well received thus far, with only a very few members exercising their right to withdraw from membership before implementation.

In general, the provisions of the GLB Act have been very positive for the FHLBanks and their members. These changes have had, and will continue to have, a positive impact on the Banks' ongoing ability to fulfill their statutory role, and to do so safely and soundly.

Federal Home Loan Banks Financial Profile

Reflecting the expansion of their membership base, the overall growth in the banking industry, and increased usage of FHLBank advances and AMA programs, the 12 FHLBanks have grown considerably in the last decade. As of June 30, 2003, the FHLBanks had combined total assets of $809 billion. The FHLBanks' balance sheets were supported by nearly $38 billion of capital, of which more than $36 billion represented capital stock contributed by member institutions. The FHLBanks' aggregate capital-to-assets ratio was 4.7 percent at June 30, with capital ratios for individual FHLBanks ranging from 4.2 to 5.6 percent.

Of the FHLBanks' total assets, $596 billion (74 percent) represented direct funding of member assets through advances and AMA. The FHLBanks' aggregate advances were $506 billion at June 30, representing 63 percent of their combined balance sheets, and AMA were $90 billion, accounting for about 11 percent of the FHLBanks' aggregate assets. The remaining $209 billion (26 percent) of the FHLBanks' balance sheets were comprised primarily of various highly rated investments that the FHLBanks hold to maintain a ready supply of liquidity to satisfy member demand for advances and AMA, and to supplement earnings to keep advances rates low and maintain adequate returns on members' capital stock investment. Approximately $78 billion of the FHLBanks' investments were in short-term

instruments such as Federal funds sold or commercial paper used by the FHLBanks to warehouse liquidity to meet members' credit needs and the FHLBanks' other day-to-day obligations.

The FHLBanks also maintain longer-term investment portfolios that provide a source of standby liquidity and supplement earnings so the FHLBanks can provide advances and other credit products at attractive rates. At June 30, 2003, the FHLBanks' longer-term investment portfolio represented about 16 percent of their total assets and included $23 billion in securities issued by the U.S. Government or U.S. agencies, approximately $6 billion of securities issued by state or local housing agencies to support their housing finance activities, and approximately $98 billion of mortgage-backed securities. The FHLBanks' mortgage-backed securities have been purchased in accordance with Finance Board guidelines not to exceed three times an individual FHLBank's total capital. These securities are all issued by the U.S. Government or U.S. agencies, or rated triple-A when they are purchased by the FHLBanks.

After weathering the storm of the thrift crisis of the late 1980's and its aftermath, the FHLBanks have been consistently profitable throughout the past decade. Although actual earnings and rates of return have fallen with the decline in interest rates over the last 3 years, this reduction in earnings is a natural and expected result of the way the FHLBanks are structured and how they operate. Because the FHLBanks are wholesale institutions investing primarily in fully secured advances, high credit quality mortgage loans or highly rated investment securities, they operate on very narrow interest spreads between their cost of funds and the yields on their assets. It is typical for a FHLBank to have a net interest spread (the difference between the cost of its liabilities and the yield on its assets) of about 20 basis points (0.20 percent). By way of comparison, a commercial bank might have an interest spread closer to 400 basis points (4.0 percent). Given the FHLBanks' small interest spreads, a much greater proportion of the FHLBanks' earnings are derived from the investment of capital than is the case for commercial banks.

Before paying dividends to members, the FHLBanks' earnings from these and other sources must cover the FHLBanks' operating expenses and assessments. These assessments include the expenses of the Finance Board and the FHLBanks' obligations to contribute 20 percent of their earnings toward the payment of interest on REFCORP bonds issued in the early 1990's to help finance the cost of resolving the thrift institution crisis, and an additional 10 percent to fund their own regional AHP.

As interest rates have fallen (particularly short-term interest rates such as the Federal funds rate which is now at 1.0 percent), the return on a FHLBank's investment of its capital has necessarily fallen as well. If a FHLBank could completely insulate itself from interest rate risk by perfectly match funding all of its assets and maintaining a constant interest spread as interest rates fall, it would expect its rate of return on invested capital to fall about 75 basis points (0.75 percent) for every 100 basis point (1.0 percent) reduction in interest rates.

Because of this dynamic, the FHLBanks' earnings and rates of return generally rise and fall with the level of interest rates, and our dividend rates follow suit. In the case of the Dallas Bank, we paid dividends at an average rate of 6.36 percent in 2000 when the average Federal funds rate was about 6.25 percent, while we expect to pay dividends at an annual rate of 2.0 percent in the third quarter of this year, with the Federal funds rate at 1.0 percent.

Our experience indicates that this result fits very well with our members' investment expectations. Members do not invest in FHLBank capital stock with the expectation of earning equity investment returns. Rather, members' investment in FHLBank capital stock represents a very low-risk asset with explicit returns in the form of dividend payments that fluctuate with market interest rates, and overall benefits that include the value of access to FHLBank funding. The FHLBanks do not attempt and are not expected to produce rates of return comparable to other equity investments.

Corporate Governance of the FHLBanks: The Role of the Board of Directors

Congress established a unique ownership and governance structure for the FHLBanks, which has served the FHLBanks well in the past and continues to do so. The most critical feature of this structure is that the FHLBanks are wholly owned by their members/customers. In addition, the boards of directors of the FHLBanks are truly independent of management. No member of management may serve as a director of a FHLBank, and management is precluded by regulation from recruiting directors or participating in the election of directors.

The Bank Act provides that a majority of each FHLBank's directors be elected by its member institutions from among officers and directors of those institutions. Members vote for directors representing member institutions from their States. The FHLBanks' members currently elect approximately 57 percent of the FHLBanks' directors in this way, with the remaining directors being appointed by the Finance Board.

Not only are members assured of the ability to elect the majority of their FHLBank's directors, but the Bank Act also provides that no member may cast a number of votes greater than the average number of shares all the members in its specific state are required to hold. This prevents large members holding relatively large amounts of a FHLBank's capital stock from dominating director elections and, in practice, means that the majority of each FHLBank's elected directors generally represent the small institutions that make up the great majority of all members.

The statutory framework that controls the composition of the FHLBanks' boards of directors ensures that each FHLBank's board of directors will have a balance of interests represented. With no members of management on the board of directors, directors are in a position to independently oversee management actions. The members that contribute capital and benefit from the FHLBank's products and services are assured a majority of the directors. The director election voting preferences for small members ensure that larger members cannot dominate the board of directors and that a FHLBank's policies will not be detrimental to small members. Finally, the large contingent of appointed directors ensures that the FHLBanks will appropriately consider their public policy obligations.

Finance Board regulations require that the FHLBanks' boards of directors not only fulfill the typical corporate director duties of care and loyalty, but that they also carry out specific responsibilities. These duties include, but are not limited to, the responsibility to select and oversee management, the responsibility to ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, and a member products policy that details the Bank's credit and pricing policies, and the responsibility to approve the FHLBank's annual operating budget and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. Finance Board regulations require each FHLBank's board of directors to have an audit committee with very specific regulatory responsibilities, including direct oversight of the FHLBank's internal and external audit functions. The boards of directors also typically establish other committees to facilitate their oversight of management. Committees vary from FHLBank to FHLBank, but typically include risk management, human resources, and housing oversight functions. The various elements of the FHLBanks' corporate governance structure combine to provide boards of directors that are active, knowledgeable, and engaged, and that are fully aware of their responsibilities and take them seriously.

Regulatory Oversight of the FHLBanks

The combination of this governance structure and the regulatory oversight provided by the Finance Board make the FHLBanks among the most intensively audited entities in the country. As noted above, each FHLBank has its own independent internal auditor, who actively and regularly audits all FHLBank operations and reports directly to the board of directors. In addition, each FHLBank's financial statements are reviewed by an outside accounting firm (currently PricewaterhouseCoopers). Finally, the Finance Board's "primary duty" under the Bank Act is "to ensure that the Federal Home Loan Banks operate in a financially safe and sound manner."

The Finance Board is not limited by funding constraints in carrying out its declared focus of ensuring the FHLBanks' safety and soundness because its funding is provided by assessments on the FHLBanks that are not subject to review or challenge by the FHLBanks. The Finance Board not only has regulatory authority over the FHLBanks that extends beyond that which is typically afforded a safety and soundness regulator—the GLB Act extended to the Finance Board the regulatory enforcement powers of both the Federal banking regulatory agencies and the Office of Federal Housing Enterprise Oversight (OFHEO) and—but also has wide-ranging authority over many aspects of FHLBanks' operations.

Finance Board regulations govern every facet of the FHLBanks' operations, from advances pricing to eligible collateral to risk management to capital plans to directors' responsibilities to new business activities. The Finance Board also collects and monitors financial and risk management data from the FHLBanks each month, performs ongoing reviews of all aspects of the FHLBanks' operations and conducts annual on-site examinations of all 12 FHLBanks. While the FHLBanks do not always enjoy being subjected to regulatory scrutiny, all believe that it is essential that the

FHLBanks have a strong, independent regulator with the resources to ensure the FHLBanks' safety and soundness.

Risk Management of the FHLBanks

As 12 independent institutions, all the FHLBanks are responsible for their own risk management activities. Each FHLBank has its own risk profile and approaches management of its risks in a slightly different way. However, there are a number of factors that are held in common across the FHLBanks that enable each FHLBank individually, as well as the Consolidated Obligations (CO's) issued by the 12 FHLBanks collectively in the capital markets, to be rated triple-A.

The cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk profile, and in fact discourages FHLBanks from taking excessive risk. Just as FHLBank members do not expect equity investment returns on their capital stock investment in a FHLBank, they also do not expect equity investment risk in that investment. Members purchase FHLBank capital stock in order to obtain access to FHLBank funding products, and must maintain capital stock investments in the FHLBank as long as they maintain advances outstanding. That is, members provide the capital that supports their advances transactions with the FHLBanks. In that environment, members expect stability, reliability, and consistency of returns and credit product pricing. These member expectations are reflected in the oversight provided by each FHLBank's board of directors, a majority of which is comprised of directors representing and elected by member institutions.

In large part due to the incentives created by the FHLBanks' cooperative structure, risk aversion and conservative risk management practices are ingrained in the corporate culture. That same conservative approach to risk management is also reflected in both the legal restrictions and the Finance Board's regulatory regime. For instance, the Bank Act and the Finance Board's implementing regulations clearly describe and mandate the various limitations on the types of collateral the FHLBanks may accept to secure advances. Regulations limit the types, amounts, and required credit ratings on both short and long term investments the FHLBanks make with surplus funds. Finance Board regulations include separate additional restrictions on the aggregate amount, ratings, and characteristics of mortgage-backed securities the FHLBanks may purchase and hold.

In addition, Finance Board regulations require that each FHLBank maintain a Risk Management Policy, reviewed at least annually and readopted at least every 3 years by its board of directors, which identifies specific risk management practices and limits for the individual FHLBank. These practices and limits are monitored by the FHLBanks' internal audit departments, which report their findings directly to the FHLBanks' boards of directors. The Finance Board also monitors FHLBank compliance with these and other regulatory requirements through monthly call reports, constant off-site monitoring, and annual on-site examinations. The FHLBanks are also subject to very conservative capital requirements imposed by statute in the GLB Act and by Finance Board regulations implementing those statutory requirements. These requirements specify that FHLBanks must have total capital equal to at least 4.0 percent of their total assets, and must have sufficient permanent capital (as defined by the GLB Act) to meet a risk-based capital regime established by Finance Board regulation.

The FHLBanks minimize credit risk by ensuring that advances are fully secured, that their investments are limited to issuers or securities that are highly rated at the time the investments are made, and that their AMA have appropriate risk-sharing features. No FHLBank has ever suffered a credit loss on an advance to a member in the FHLBanks' 71 year history. As of June 30, 98 percent of the FHLBanks' investment securities have long-term ratings of triple-A or the corresponding highest short-term ratings. In addition, due in large part to the risk sharing structure of the AMA programs, the FHLBanks' loss experience on AMA assets has been very favorable.

Since each FHLBank's primary activity is to serve as a financial intermediary, the FHLBanks are also subject to market (or interest rate) risk. To the extent the individual maturities of a FHLBank's assets are not exactly matched by the individual maturities of its liabilities, the FHLBank's future earnings stream is subject to fluctuation due to changes in the relationship between yields on its assets and the cost of its liabilities. Complicating the picture is the fact that the FHLBanks hold assets (such as mortgage loans and securities) or have issued liabilities (such as callable debt) that can be repaid prior to their stated maturities. Further complicating the issue is the fact that the FHLBanks' narrow interest spreads do not provide a large margin of error.

To manage these risks, each FHLBank uses sophisticated financial models to continually assess the magnitude of the risk to the FHLBank's estimated market value or earnings from various changes in interest rates. This information is reported to the FHLBank's board of directors on a regular basis and to the Finance Board as often as monthly, and is summarized in the FHLBanks' combined financial statements.

Reflecting the FHLBanks' conservative approach to interest rate risk management, the 12 FHLBanks' "duration gaps," or (generally) the difference between the estimated average maturity of a FHLBank's assets and the estimated average maturity of its liabilities, ranged from negative 1.4 months to positive 1.6 months as of June 30, 2003. A duration gap of 1.6 months generally means that the weighted average expected maturity of a FHLBank's assets is 1.6 months longer than the weighted average expected maturity of its liabilities.

The FHLBanks use interest rate derivatives extensively to maintain their conservative interest rate risk profile. While much has been written about the potential risks that can be created by the improper use of derivatives, the manner in which the FHLBanks use derivatives is a key component of their risk management activities. A couple of facts are germane to an understanding of the FHLBanks' use of derivatives.

First, Finance Board regulations prohibit the use of derivatives for speculative purposes. That means that every derivative instrument entered into by a FHLBank is designed to hedge (that is, reduce) an identified risk. Second, a majority of the FHLBanks' interest rate derivative transactions are structured to exactly offset another specific transaction. For instance, a FHLBank may use an interest rate swap to convert the interest payments on a particular fixed rate advance to a floating rate, so that the net payment stream will float in a manner that matches the debt the FHLBank has issued to fund the advance. Similarly, much of the debt the FHLBanks issue is long term, fixed rate, and often callable. The FHLBanks typically convert a large portion of this fixed rate debt to floating rates by executing exactly offsetting interest rate swaps simultaneously with the issuance of the debt. Approximately 82 percent of the FHLBanks' outstanding derivatives as of June 30, 2003 represented these two types of transactions.

While the use of interest rate derivatives is critical to managing the FHLBanks' interest rate risk, derivatives can cause problems if not managed appropriately. The FHLBanks mitigate these risks in several ways. The appropriateness of the FHLBanks' derivatives activities for risk management purposes are validated internally by the use of internal valuation models, by internal audits that often employ external experts to validate a FHLBank's valuation model and hedging practices, by external audits of the FHLBank's derivative valuations, and through the Finance Board's annual on-site examination process.

The use of derivatives can also increase credit and operational risks that must be managed carefully. For instance, derivatives pose credit risk created by the potential for default by derivative counterparties. The FHLBanks mitigate this risk by engaging in derivatives transactions only with highly rated counterparties, and maintaining bilateral collateral agreements with each counterparty that require that the net fair value of derivatives positions be calculated periodically and collateral exchanged to the extent that the FHLBank is exposed to risk of default beyond some small threshold.

It should be noted that the magnitude of the potential counterparty credit risk of a derivatives portfolio has little to do with the aggregate notional amount of the derivatives. The potential credit risk is represented by the net fair value of the portfolio of derivatives between a FHLBank and a particular counterparty. For instance, the aggregate notional amount of the FHLBanks' interest rate derivatives as of June 30, 2003, was $694 billion. However, the net fair value of those derivatives represented a fair value loss to the FHLBanks (not including offsetting fair value gains on hedged instruments) of $16 billion.

Each FHLBank's credit exposure created by its derivatives portfolio is determined by netting the current fair value of the derivatives by counterparty, as provided in the FHLBanks' bilateral collateral agreements. After taking that step, the FHLBanks' total aggregate counterparty credit exposure was $2.2 billion before taking into consideration collateral held to offset that exposure. After taking collateral into consideration, the FHLBanks' aggregate net exposure was $435 million, about one-third of the FHLBanks' aggregate retained earnings. Of the FHLBanks' aggregate net exposure, $125 million of the exposure was to triple-A rated counterparties, $228 million to double-A rated counterparties, and $82 million to single-A rated counterparties.

One of the primary operational risks related to derivatives is the risk of inaccurate accounting for those instruments, particularly since the implementation of

Statement of Financial Accounting Standard 133, *Accounting for Derivatives and Certain Hedging Transactions* (SFAS 133) in 2001. That statement requires generally that derivatives be carried on the balance sheet at fair value, prescribes the appropriate income recognition for changes in fair value of derivatives, and specifies criteria that must be met in order for hedged instruments to qualify for hedge accounting.

The FHLBanks have gone to great lengths to apply SFAS 133 appropriately and ensure that all derivatives accounting complies with generally accepted accounting practices (GAAP). Prior to implementation of the accounting standard, the FHLBanks' controllers formed an inter-FHLBank task force, which included representatives from the FHLBanks' external audit firm, to catalogue the various types of derivatives transactions on the books of the FHLBanks, identify the appropriate accounting treatment for each, and develop an accounting guide used across the 12 FHLBanks to ensure consistency. This task force has remained in place since the implementation of the standard to ensure ongoing accounting consistency and compliance with GAAP. In addition, the FHLBanks' external audit firm reviews each FHLBanks' derivatives accounting as part of its quarterly reviews and annual audits of their financial statements.

FHLBank Financial Reporting and Disclosure

There has been much discussion recently about the appropriate forum for the FHLBanks' financial reporting and disclosure. We believe that it is most important to focus carefully on the precise nature of the issue under consideration. All 12 FHLBanks are fundamentally committed to provide complete and state of the art disclosure consistent with the unique characteristics of the FHLBanks as established by Congress.

Under the FHLBanks' current financial reporting and disclosure regime, the FHLBanks' combined financial statements are required by Finance Board regulation to comply with most Securities and Exchange Commission (SEC) reporting requirements, except those specifically excluded by the regulation. The individual FHLBanks' financial statements are required to be consistent in form and content with the combined financial statements. Both the FHLBanks' combined statements and their individual financial statements comply with GAAP as certified by the FHLBanks' external auditor. In addition, all 12 FHLBanks are evaluating ways to enhance their financial reporting and disclosure in accordance with evolving best practices. As part of that consideration, for instance, it is my understanding that all 12 FHLBanks are currently preparing to voluntarily comply with the requirement for attestation of internal controls as set forth in Section 404 of the Sarbanes-Oxley Act, and evaluating the applicability of other aspects of that legislation.

The matter under discussion is not disclosure, but rather the request by the Chairman of the Finance Board and others within the Administration that the FHLBanks voluntarily register with the SEC. The FHLBanks take these requests very seriously and have devoted a great deal of time and resources to considering the appropriate application of SEC standards—designed for publicly traded companies—to cooperatives whose capital stock is not traded, has a fixed value and is only held by member financial institutions. In order for our boards of directors to carry out their legal fiduciary duty, they must carefully consider the potential effects of voluntary registration on the FHLBanks, their members and the fulfillment of the FHLBanks' mission.

We are involved in ongoing discussions with SEC staff on how voluntary registration of the FHLBanks would be implemented. While some key threshold issues appear to have been resolved in a workable way, other important issues remain to be resolved, as does the form of the agreement between the FHLBanks and the SEC that would memorialize the resolution of those issues.

Conclusion

Over its long history, the Federal Home Loan Banks have played a vitally important role in supporting their member financial institutions' ability to meet the housing finance and credit needs of their local communities. The FHLBanks remain economically strong today and continue to serve a vital function for their financial institution members and the communities they serve.

PREPARED STATEMENT OF DAVID W. HEMINGWAY

DIRECTOR, FEDERAL HOME LOAN BANK OF SEATTLE
EXECUTIVE VICE PRESIDENT, ZIONS FIRST NATIONAL BANK

SEPTEMBER 9, 2003

Good afternoon Chairman Bennett, Ranking Member Johnson, and Members of the Subcommittee. I am David Hemingway, Executive Vice President of Zions First National Bank, based in Salt Lake City, Utah, and a Member of the Board of Directors of the Federal Home Loan Bank of Seattle.

I would like to thank Chairman Bennett and the Subcommittee for the opportunity to speak this morning on behalf of the Federal Home Loan Banks and address the critically important issue of corporate governance and responsibility within the Bank System.

As both a community banker for the better part of three decades, and an elected member of the board of directors of the Federal Home Loan Bank of Seattle, the issue—and practical application—of board governance is of paramount importance to the financial institutions and communities we serve every day, and to me, personally. Simply put, I am accountable for the safety and soundness of the Seattle Bank.

While I am not alone in that role—I share it with 17 other directors and the management team of the company—I consider it my job to ensure that the financial management of this $47 billion bank is effective over the long-term, including proper stewardship of our shareholders' capital.

That is a staggering responsibility when you consider that the funding provided within the Seattle Bank district fuels housing finance, affordable housing initiatives and economic development in communities from Pago Pago to Walla Walla, Washington. Our nearly 400 member institutions rely on the Federal Home Loan Bank of Seattle to be their partner in helping their communities and local economies not only survive, but thrive.

Across the Federal Home Loan Bank System, we partner with nearly 8,000 community financial institutions in extending affordable credit to communities in every region of the United States. The Federal Home Loan Banks hold nearly $800 billion in assets, provide nearly a half trillion dollars in advances annually, issue about $200 million in affordable housing grants yearly, and hold nearly $100 billion in mortgage assets.

So when elected to serve as a director of the Federal Home Loan Bank of Seattle, I understood the critical importance of my role and what I needed to bring to the board—namely, my personal integrity and accountability, and my financial services and community banking expertise.

Over the last several years, we have witnessed corporate failures of historic proportions—financial disasters brought on by a combination of inept business practices, poor leadership and financial oversight, and fraudulent and unethical behavior. We are all well aware that a quantum shift has occurred in how American corporations—large and small, privately held or publicly traded—will be run. Must be run.

The term used most these days is "corporate governance." It is now in our business vernacular; it makes headlines in *The Wall Street Journal*; it comes out of the mouths of network anchors on a frequent basis. But I believe there is another way to state it, and it goes something like this: Those who get to exercise the power must be accountable to those who are affected by it.

We share with our regulator, the Federal Housing Finance Board, the Treasury, and Congress the sense of urgency that is so pervasive today regarding the need for increased accountability and responsibility. And we have worked hard over the last several years to significantly strengthen the leadership and oversight of our banks.

While we fully understand that corporate governance is a process; a discipline that can—and must be—constantly improved, I am personally and professionally encouraged by the intensity of our efforts and the progress being made.

Over the course of the last year, the Seattle Bank board has created, adopted, and publicly disclosed a set of Core Principles and Guidelines relating to board governance, realigned our board committee structure to more effectively oversee all facets of the bank's operations, upgraded our education and training program for directors, and established a website that provides directors with faster access to a wider range of information critical to their board roles.

Our Core Principles and Guidelines provide us with a corporate governance roadmap, if you will, keeping us focused on:

- Assuring that policies, risk assessments, internal controls and decisions are effective in managing risk and are administered fairly.

- Operating in an independent and active manner.
- Setting the strategic direction of the bank and managing progress against goals.
- Determining if management is capable and if the business is being properly managed.
- Evaluating our own board effectiveness.

Our regulator, the Federal Housing Finance Board, is also diligent in overseeing and supporting sound corporate governance practices across the Bank System. The Finance Board just recently completed a horizontal review designed to assist the Agency in directing and developing its supervisory and regulatory initiatives. The comprehensive review provided all 12 banks with a valuable resource for identifying practices that contribute to effective governance programs. The Finance Board interviewed management and board members, and reviewed a wide range of bank documents with respect to board policies, practices, and decisions.

I offer these comments to underscore the ongoing value of having boards and bank management teams focused on enhancing corporate governance standards, and a regulator performing its supervisory duty in a way that provides additional information and resources that further enhance the safety and soundness of the Bank System. As we all know, it is one thing to say your house is in order and quite another to prove it. As a director—and a member and owner of the Seattle Bank—it is my job to prove it.

Does your board audit committee provide effective oversight of the internal and external audit functions? Is the audit function independent, reporting only to the board, and is it supported appropriately by directors? Does the board ensure that material risks are accurately and consistently assessed by management and reported to the board in compliance with regulation and prudent business practice? Are all directors working responsibly in carrying out their duties? Are board and management actively involved in strategic planning?

I am pleased to say the Seattle Bank has "yes" answers to these questions posed by the Finance Board in its recent horizontal review. But that is today. Our job is to ensure that we have "yes" answers tomorrow, the next day, and the day after that. Which is a much tougher proposition. But that is our job.

We are fortunate within the Federal Home Loan Bank System when it comes to corporate governance and responsibility. We were never starting from scratch. We have had the advantage of enhancing practices and standards that have, for more than 70 years, protected the Bank System against even a single member credit loss.

But I would emphasize again that we are fully aware that a new era has dawned in American business—one that looks on corporate governance as an ongoing, rigorous discipline that demands, at all times, review and accountability.

As one of 216 directors of the Bank System cooperative, I wouldn't have it any other way.

Mr. Chairman, this concludes my written testimony. Thank you, again, for allowing me the opportunity to speak with you today. I would be happy to answer any questions you or other Members of the Subcommittee may have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES AND SENATOR CARPER FROM JOHN T. KORSMO

Q.1.a. I would just like to ask several questions regarding your examination and supervision of the Federal Home Loan Banks. What has been your total budget for the last 5 years? Of that amount, what percentage has been spent on safety and soundness supervision? Of the amount spent on safety and soundness, please specify what percentage is spent on: Examination personnel; Examiner travel; Examiner training; and Systems support? For each of the last 5 years, what has been the total number of examiners? What is the average examiner's pay? The range of examiner's pay?

A.1.a. The following tables provide answers to the questions listed above.

Finance Board Expenditures

Fiscal Year	Amount of Expenditures
1999	$17,793,158
2000	$18,693,996
2001	$19,835,448
2002	$23,195,340
2003 *	$22,826,736
2004 *	$31,070,909

* Projected

Percentage and Amount of Finance Board Expenditures Spent on Safety and Soundness Supervision

Fiscal Year	% Spent	$ Spent
1999	59%	$10,515,595
2000	50%	$9,306,769
2001	60%	$11,937,380
2002	64%	$14,771,797
2003 *	68%	$15,554,603
2004 *	77%	$23,953,978

* Projected

Percentage and Amount of Finance Board Safety and Soundness Expenditures Spent on Examination Personnel and Participating Staff*

Fiscal Year	% Spent	$ Spent
1999	17%	$1,747,484
2000	19%	$1,814,428
2001	16%	$1,856,097
2002	16%	$2,373,459
2003 **	30%	$4,670,317
2004 **	29%	$6,998,455

* Participating staff includes examiners, accountants, financial analysts, economists, and lawyers participating in examinations.
** Projected

Percentage and Amount of Finance Board Safety and Soundness Expenditures Spent on Examination Personnel Travel

Fiscal Year	% Spent	$ Spent
1999	2%	$258,675
2000	3%	$285,705
2001	2%	$279,166
2002	2%	$330,066
2003*	4%	$544,621
2004*	4%	$968,045

* Projected

Percentage and Amount of Finance Board Safety and Soundness Expenditures Spent on Examination Personnel Training

Fiscal Year	% Spent	$ Spent
1999	*less than 1%*	$23,456
2000	1%	$52,667
2001	*less than 1%*	$23,927
2002	1%	$77,104
2003*	1%	$81,142
2004*	1%	$236,746

* Projected

Percentage and Amount of Finance Board Safety and Soundness Expenditures Spent on Information Technology Systems Support

Fiscal Year	% Spent	$ Spent
1999	8%	$876,805
2000	7%	$665,115
2001	18%	$2,165,352
2002	23%	$3,391,367
2003*	15%	$2,336,983
2004*	19%	$4,593,340

* Projected

Total Number of Finance Board Examination Personnel

Fiscal Year	As of 9/30	% Change
1999	10	NA
2000	10	0%
2001	10	0%
2002*	12	20%
2003**	20	67%
2004***	36	80%

* As of Dec 31, 2001, there were 8 Bank Examiners on staff.

** As of September 30, 2003, two job offers for Bank Examiner positions had been accepted. These positions are not included in the FY 2003 year-end head count.

*** Projected

Total Number of Finance Board Staff Participating in Examinations

Fiscal Year	Number of Participating Staff* As of 9/30	% Change
1999	17	NA
2000	16	-7%
2001	16	0%
2002	21	28%
2003	35	67%
2004**	55	57%

* Participating staff includes examiners, accountants, financial analysts, economists, and lawyers participating in examinations.
* Projected

Average Salary of Examination Personnel

Fiscal Year	Average Salary
1999	$76,184
2000	$85,598
2001	$81,851
2002	$90,237
2003	$105,192
2004*	$106,093

* Projected

Salary Range of Examination Personnel

Fiscal Year	Low End of Range	High End of Range
1999	$45,039	$109,908
2000	$71,433	$101,000
2001	$45,000	$120,000
2002	$64,176	$127,920
2003	$77,190	$140,000
2004*	$77,145	$147,700

* Projected

Q.1.b. For each examiner currently employed by the FHFB, specify education level, years of examination experience, and whether or not they are accredited.

A.1.b. The examination staff, including the Deputy Director of the Office of Supervision, averages more than 17 years of professional experience in banking, mortgage finance, and bank examinations. All examiners are commissioned examiners or have a professional accreditation, and many have both.

Position	Highest Level Education	Years of Experience	Accreditations
Deputy Director	BS, Finance/Econ.	28	Commissioned Bank Examiner (CBE), Graduate School of Banking
Examiner/Associate Director	BS, Finance	19	CBE, Graduate School of Banking
Examiner/Portfolio Manager	MS, Finance	13	CBE, Chartered Financial Analyst (CFA)
Examiner/Portfolio Manager (Acting)	BS, Economics	9	Certified Public Account (CPA); CFA
Examiner	MBA	17	Certified Financial Institutions Examiner
Examiner	BS, Mgmt./ BA	25	Chartered Bank Auditor; ABA National Graduate Compliance School
Examiner	BA, Accounting	23	CBE; Certified Regulatory Compliance Manager
Examiner	MBA, Finance	16	CBE; Certified Risk Professional
Examiner	MBA, Accounting	17	Certified Investment and Derivative Auditor (CIDA)
Examiner	MBA, Finance	26	Federal Thrift Regulator (FTR)
Examiner	BBA, Finance	11	CBE; Graduate School of Banking; CFA Level II
Examiner	MBA	18	FTR; Certified Information Systems Auditor (CISA)
Examiner	BA	13	CBE
Examiner	BS, Finance	17	CBE; CISA
Examiner	BA, Economics	19	FTR; CFA Level I
Examiner	BS, Finance	10	CBE; CFA; Certified Financial Risk Manger; CIDA
Examiner	BA, Economics	16	Certified Financial Institutions Examiner
Examiner	BBA, Finance	13	CBE; CFA Level II
Examiner[1]	BA, Accounting and Economics	18	CPA, CFA Level II, Registered Securities Representative Series 7, 63
Examiner[2]	BA, Business	24	Commissioned National Bank Examiner (NBE), Graduate School of Banking.
Mortgage Analyst	BS, Business	6	CFA
Mortgage Analyst	MBA, Finance	25	Registered Securities Representative Series 7, 63

[1] Accepted position. Starts at Finance Board in October.
[2] Accepted position. Starts at Finance Board in November.

Q.1.c. How many safety and soundness examinations have you conducted in the last 12 months? How many examiners were assigned to each examination? How often do you conduct safety and soundness examinations of each bank? How many on-site examinations did you conduct during the last 12 months? How often do you conduct on-site examinations of each bank? What was the length of time spent on each on-site examination? How many examination staff conducted each on-site examination?

A.1.c. The Finance Board has a statutory requirement to examine each FHLBank at least annually as set forth in Section 1440 of the Federal Home Loan Bank Act. Accordingly, the Finance Board conducts annual on-site examinations of each FHLBank and the Office of Finance.

The Finance Board's Office of Supervision has a comprehensive program to supervise, monitor, and examine the FHLBanks. Each FHLBank is assigned an examiner-in-charge who oversees the implementation of a supervisory strategy and monitors that FHLBank on a regular basis. In addition to examination staff, accountants, financial analysts, and economists monitor trends that have the potential to affect all FHLBanks. Further, an analyst designated for each FHLBank analyzes the FHLBank's quarterly and annual financial results and monitors developments at the FHLBank. The Office of Supervision also has a risk modeling division that is charged with evaluating and validating the FHLBanks' risk modeling results and assumptions. Finally, the Office of Supervision has a risk monitoring division that, among other duties, is charged with monitoring the quality of data submitted by each of the FHLBanks.

Finance Board supervision of the FHLBanks is predicated on the principle that banking is a business of managing risks. Indeed, FHLBanks must continually manage risks in selling debt, underwriting advances, evaluating collateral, acquiring mortgages and mortgage backed securities, setting dividend and retained earnings policies, managing liquidity positions, swapping cashflows, and using derivatives to hedge market risks. Decisions in each of those areas are made separately by each FHLBank pursuant to the policy direction and risk limits established by the FHLBank's Board of Directors.

It has not always been this way. Until the passage of the Gramm-Leach-Bliley Act (GLBA) in 1999, the Finance Board was actively involved in a number of key operating decisions for the FHLBanks—such as setting dividend payouts and preparing the FHLBanks' combined quarterly and annual financial statements. Finance Board examinations were little more than checklists designed to assess the FHLBanks' compliance with Finance Board regulations.

Today, day-to-day operating decisions are properly the responsibility of the individual FHLBank, pursuant to the policy direction established by its Board of Directors. Our examiners do not substitute their judgment, on individual business decisions, for the decisions made by the FHLBank's management or board. However, our examiners review the framework within which those decisions are made. In particular, our examiners evaluate the risk management policies and controls established by the FHLBank's Board of

Directors and assess the adequacy and effectiveness of the FHLBank's policies and practices in identifying, measuring, monitoring, and controlling risks.

FHLBank examinations are typically conducted over an 8-week period, with the on-site portion of the examination lasting 4 weeks. During the period prior to the on-site portion of the examination, Finance Board examiners spend several weeks conducting preliminary analyses and reviews of FHLBank records, and defining the scope of the on-site portion of the examination. During the on-site portion of an FHLBank examination, a team typically consisting of 6 to 10 staff members from the Finance Board travel to the FHLBank to conduct the examination.

In the period following the on-site portion of the examination, Office of Supervision staff prepares and presents examination findings to the FHLBank's Board of Directors. The FHLBank's Board of Directors is responsible for reporting back to the Finance Board its actions taken in response to the findings in the examination report. Finance Board staff conduct quarterly follow up reviews to monitor the progress of the FHLBank in addressing the findings of the report of examination.

Over the past year, both the number of examination staff on-site and the length of examinations have generally increased. Our efforts to hire well-qualified examiners are beginning to realize results, as measured by the number of examiners we are able to devote to each examination, and by the quality of the examinations. Examination statistics over the year are as follows:

- The length of an FHLBank examination is typically 8 weeks, including 4 weeks on-site. As warranted, the on-site period is extended. In one 2003 examination, for example, the on-site portion lasted 6 weeks.
- During 2003, the number of staff on-site at the FHLBanks during an examination normally ranged from 6 to 10. The Office of Supervision devotes more staff to an examination as conditions warrant.
- During 2002, all 12 FHLBanks and the Office of Finance were examined.
- During 2003, all 12 FHLBanks and the Office of Finance will be examined. To date, 10 FHLBanks have been examined during 2003.
- During 2003, we installed a "resident examiner" (an examiner operating full-time on-site) for 6 weeks prior to the scheduled examination for one FHLBank.
- During 2003, the Finance Board also conducted System-wide (or "horizontal") reviews of the effectiveness of board governance and of the operations of the Affordable Housing Program (AHP) at the 12 FHLBanks.

Q.1.d. Without revealing the names of individual institutions, how many examinations identified "problem" areas? What were these problem areas?

A.1.d. All FHLBank examinations in 2002 and 2003 identified matters that required the attention of the management and Board of the FHLBank. Not all of these matters would necessarily be "problems." There were instances, however, where the seriousness of the

examination "findings" resulted in the Finance Board seeking specific action by an FHLBank's Board of Directors.

There are eight "findings" categories defined in the endnotes of each safety and soundness report of examination. They are identified in such a way as to convey the seriousness or nature of the "finding."

All examinations conducted in 2002 and 2003 identified matters that resulted in "recommendations" from the Finance Board to the FHLBank. "Recommendations" represent the mildest "findings" included in a report of examination. Most examinations also resulted in "findings" that included "weaknesses," "exceptions," "resolved violations," and "violations." In six FHLBanks, the examination "findings" or related supervisory activities resulted in the Finance Board seeking specific corrective or preventative action by the FHLBank's Board of Directors. In those cases, the FHLBank was required to address deficiencies in:

- Risk assessment and controls programs;
- Board and management oversight;
- Affordable Housing Program oversight;
- Risk modeling;
- Credit analysis;
- Strategic planning; or
- Documentation of hedging activities.

Q.1.e. Over the past 5 years, how many enforcement actions has the FHFB taken against the FHLBanks? Please list each action.

A.1.e. Prior to the passage of the Gramm-Leach-Bliley Act in 1999 (GLBA), the Finance Board's statutory enforcement authorities were limited to suspension and removal powers over any director, officer, employee, or agent of any FHLBank or joint office, for example, the Office of Finance. GLBA gave to the Finance Board enforcement powers similar, but not identical, to those of the banking agencies. In particular, the Finance Board was granted statutory cease and desist authority.

As is typical of any banking regulator/supervisor, the Board enforces regulations and the safe and sound conduct of its regulated entities in three ways. In the majority of cases we detail statutory or regulatory violations and operating deficiencies in an examination report or, if the violation or deficiency is noted through our off-site monitoring of the FHLBank, by formal notification to the FHLBank. Our examination reports are sent to each board member of the FHLBank, and presented in detail at a meeting of the full board of directors shortly after the completion of the on-site examination. Where appropriate, we require the FHLBank to take remedial actions. We check the sufficiency of those actions by requiring a response from the FHLBank and by following up during the on-site portion of the next examination of the FHLBank. In virtually every case where such operating deficiencies or violations have been cited, the FHLBank board and management have corrected the deficiencies or violations in the normal course of business.

If an unsafe or unsound condition or practice that threatens the safety of an FHLBank were to be noted, the Office of Supervision would take a formal enforcement action to correct and/or reverse the condition or practice. Over the past 5 years, there have been

numerous occasions when our examiners or analysts have noted operating deficiencies at the FHLBanks. Less frequently, they have noted situations where the FHLBanks have violated statutes or regulations. There have not been occasions where our examiners have cited violations or deficiencies that have risen to a level that would threaten the safe and sound operation of an FHLBank. Consequently, no formal enforcement actions have needed to be taken against any FHLBanks.

Between those situations where normal course-of-business operating deficiencies and/or violations have been cited, and where unsafe or unsound conditions or practices have been noted, we employ "preemptive" supervisory strategies. Specifically, we strongly encourage an FHLBank's Board of Directors to exercise its fiduciary responsibilities by taking action to assure the safe and sound operation of the FHLBank. Where we believe it necessary, we communicate to the board of directors our view that it needs to intercede more actively. That exercise of responsibility and authority by an FHLBank's board normally takes the form of a board resolution and follow-up action plan, together with regular reporting by management to the board or to an appropriate committee thereof. It is also customary for us to receive, as part of our supervisory activities, copies of those resolutions and copies of status reports regarding progress. In addition, we offer comments on the sufficiency of those actions plans and/or progress reports.

Over the past 5 years, and particularly over the past 12 months, we have worked with the boards of directors of the FHLBanks to improve their operations or to correct ongoing deficiencies. In most cases, particularly in the past 12 months, our efforts have been aimed at enlisting the boards of directors to improve the risk management practices of their institutions. A brief description of those actions is provided below. In several cases, our actions took the form of notifying an FHLBank's board that the implementation of its approved capital plan should not move forward until noted and cited deficiencies had been corrected.

- In one case, the Board of Directors of an FHLBank postponed the scheduled conversion to its new capital structure until the examination-cited deficiencies in the FHLBank's planning and risk management practices were addressed to our satisfaction.
- In response to our supervisory concerns, an FHLBank's Board of Directors postponed conversion to its new capital structure until the FHLBank had enhanced its risk assessment and risk management practices.
- At our behest, an FHLBank postponed its capital conversion and suspended dividends in light of operating losses and risk management deficiencies.
- Based on discussions with the Office of Supervision, the Board of Directors of an FHLBank agreed to analyze and revise its retained earnings and dividend policies before declaring or paying dividends.
- Based on examination-cited deficiencies in risk assessment and risk management practices, two FHLBanks' boards of directors have limited growth and committed to maintaining their capital positions until those deficiencies have been corrected. One of

those FHLBanks has also committed to suspend requests for new business activities.

- Based on examination-cited deficiencies in the administration of its Affordable Housing Program, the Board of Directors of an FHLBank contracted for an independent third-party review of its program.

Again, these actions, while not specifically characterized as formal enforcement actions, are examples of recent instances where the Finance Board has used its available supervisory tools to promote the safe and sound operation of the FHLBanks. As is normal for any bank regulator, the actions taken by boards of directors as a result of discussions with us are part of a supervisory effort aimed at preventing, rather than reacting to, unsafe and unsound conditions.

Q.2.a. The Pittsburgh FHLBank suffered a very bad second quarter. Based on its most-recent financial reports, its annualized return on assets is 0.02 percent. Its capital stands at $2.25 billion, or 4.2 percent of assets, barely above the regulatory minimum. Its second-quarter dividend was subsidized with $10 million from retained earnings. How do you explain the Pittsburgh FHLBank's poor performance?

A.2.a. After reporting net income of $15.3 million for the first quarter of the year, Pittsburgh's net income fell to $2.4 million for the second quarter. Three principal factors depressed the FHLBank of Pittsburgh's earnings in the second quarter.

First, low market rates adversely affected the Pittsburgh FHLBank's net income. To the extent that an FHLBank invests member capital primarily in short- or intermediate-term instruments, the rate of return on these investments, and thus the return on its equity, will move in tandem with short-term interest rates.

Second, as assets prepaid faster than debt was retired, compressed interest margins reduced net income. The Pittsburgh FHLBank experienced higher than expected prepayment on mortgages and securities backed by mortgages in the second quarter. The Pittsburgh FHLBank was using previously issued long-term debt to support its operations. That debt, issued principally in 1994 and 2000, carries relatively high interest rates, ranging from approximately 4.0 to 6.3 percent, reflecting market rates at the time of issuance. In the lower interest-rate environment during the second quarter, margins were compressed and earnings declined. Margins will continue to be squeezed until that debt is retired or asset yields rise. The Pittsburgh FHLBank has reported that the higher cost debt will begin to roll off in July 2004.

Third, during the second quarter, the recognition of substantial premium amortization expenses associated with the prepayment of mortgage loans significantly reduced the Pittsburgh FHLBank's net income.[3]

There are three components to mortgage premium amortization.

[3] If a mortgage with a coupon rate that matches the current market rate sells for $100, then a mortgage with a coupon rate above the current market rate will sell for more than $100, since it offers higher cashflows. The amount in excess of $100 is the "premium" associated with that mortgage.

- When a loan is purchased at a premium (normally due to an interest rate on the loan that is above the current market level), accounting rules require the holder to amortize the premium over the loan's expected life. This represents regular amortization of the premium.
- When a loan is prepaid, any unamortized premium associated with that particular loan must be written off immediately because that that loan is no longer on the institution's books and the mortgage's cashflow ceases.
- The amortization of the premium associated with loans remaining in portfolio must be adjusted to reflect current prepayment speeds. When interest rates fall and prepayment rates rise, amortization rates increase. This is normally referred to as "catch-up" amortization.[4]

The Pittsburgh FHLBank currently limits its exposure to accelerated premium amortization by using interest-rate floors.[5] The Pittsburgh FHLBank has reported to the Finance Board that it is reevaluating the most effective hedge vehicles available and is limiting growth in its net premium exposure.

Q.2.b. Why did FHFB supervisors allow the Bank to pay a subsidized dividend given its poor performance?

A.2.b. Prior to the passage of GLBA, the Finance Board approved dividends paid by the FHLBanks. GLBA devolved the responsibility to set dividends to the FHLBank boards of directors. One focus of the Finance Board's supervision of the FHLBanks has been to ensure that the FHLBanks' boards of directors exercise this authority appropriately and in compliance with Finance Board regulations.

Finance Board regulations prohibit an FHLBank from paying a dividend if it would result in the FHLBank failing to meet any of its capital requirements (*See* 12 CFR § 931.4). The FHLBank of Pittsburgh met all of its capital requirements after the payment of the second-quarter dividend. However, we have communicated our concerns to the Pittsburgh FHLBank about their paying a dividend in excess of their quarterly net income.

In August 2003, the Office of Supervision issued Advisory Bulletin 03–08 instructing each FHLBank to adopt a retained earnings policy that specifically assesses the adequacy of retained earnings in light of alternative future financial and economic scenarios, and prioritizes retained earnings over dividends. On October 8, 2003, the Finance Board, during an open board meeting, took the position that an FHLBank should not use retained earnings to pay a dividend to its members unless and until that FHLBank meets the standards set in Advisory Bulletin 03–08.

We monitor dividends and retained earnings in our supervisory program. The Finance Board has expressed to the FHLBanks its

[4] Statement of Financial Accounting Standards No. 91, *Non-Refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (SFAS 91), governs the accounting for mortgage premiums and discounts.

[5] As employed by the FHLBanks, a floor is an interest-rate exchange agreement where the FHLBank pays a fixed fee up front and the counterparty pays the FHLBank the difference between 3-month LIBOR and some specified interest rate if 3-month LIBOR falls below that specified rate. Thus, the FHLBank buying a floor expects the gains from the floor to offset premium amortization when interest rates fall.

concern about the relatively low levels of retained earnings at a number of the FHLBanks. Advisory Bulletin 03–08, mentioned above, requires:

- Each FHLBank to assess the adequacy of its retained earnings in an analytically rigorous fashion using a variety of truly stressful scenarios;
- The Board of Directors of each FHLBank to review the analysis of retained earnings of that FHLBank, and
- Each FHLBank to establish a formal retained earnings policy.

We will review those analyses and retained earnings policies during our 2004 examinations.

Q.2.c. What will happen if bank regulators mark down the Pittsburgh Bank stock?

A.2.c. A write-down of the Pittsburgh FHLBank's capital would occur only if the capital stock were impaired and this impairment were viewed as other than temporary. The Pittsburgh FHLBank's stock is not impaired. Members can purchase and redeem stock in the FHLBank of Pittsburgh at par.

Q.2.d. Please describe the supervisory steps you will take when an FHLBank's capital falls below required levels. At what point do you take supervisory action? Do you wait until the minimum capital requirement is violated?

A.2.d. As a practical matter, because of their portfolio composition, FHLBanks should not fall out of compliance with the minimum capital requirements. An FHLBank that approaches its regulatory capital minimum should be able to sell assets (or not roll over short-term asset positions) to remain in capital compliance.

In addition, Finance Board regulations prohibit the payment of any dividend by any FHLBank if the payment would result in that FHLBank failing to meet any of its minimum capital requirements (*See* 12 CFR § 931.4). Finance Board regulations also prohibit any FHLBank from redeeming or repurchasing any capital stock if the FHLBank would fail to meet any minimum capital requirement after the redemption (*See* 12 CFR § 931.7(c)). Furthermore, an FHLBank may not redeem or repurchase any capital stock without the prior written approval of the Finance Board if the Finance Board or the Board of Directors of the FHLBank has determined that the FHLBank has incurred or is likely to incur losses that result in or are likely to result in charges against the capital stock of the FHLBank (capital impairment) (*See* 12 CFR § 931.8(a)).

The Finance Board also has in place a comprehensive regulatory structure to facilitate prompt supervisory action before any FHLBank would violate the minimum capital requirements. First, the FHLBanks must submit monthly, as well as more extensive quarterly, call reports to the Finance Board.[6] Second, the Finance Board has designated an examiner-in-charge (EIC) for each FHLBank. The EIC assignment is for a multiyear period to provide

[6] The call report is the principal way an FHLBank reports financial information to the Finance Board. There are both monthly and quarterly reporting requirements. Balance sheet, investments, income statement, advances, leverage, derivatives, capital compliance, and credit concentration information is required monthly.

continuity of supervision of each FHLBank.[7] EIC's have formal contact with their designated FHLBank no less frequently than quarterly, and more frequently if conditions warrant. Third, the Finance Board has designated 12 financial analysts, each to serve as the principal analyst for one FHLBank. The analysts can alert the EIC, senior management, or the Board of Directors of the Finance Board about deteriorating trends at any FHLBank.

If, despite these regulatory and supervisory protections, an FHLBank's capital were to fall below required levels, the Finance Board would take formal enforcement actions with provisions to address the capital deficiency.

Q.3.a. Looking at System financial statements for the second quarter of this year, several FHLBanks had losses attributable to "derivatives and hedging operations." For example, Boston and Pittsburgh each had $14 million in losses, Atlanta had $72 million, and Chicago and Topeka each had $23 million. Of these Banks, several had reduced net income from the prior quarter—for example, Boston went from $22 million in the first quarter of 2003 to $19 million, Pittsburgh from $15 million to $3 million, and Topeka from $17 million to $11 million. Atlanta had a slight dip and Chicago had a slight increase in income. My understanding is that the average Return on Assets for the FHLBank System is generally around 1 percent, but for the last quarter it was only 0.2 percent, with one Bank earning only 0.02 percent. Are derivative losses responsible for the overall drop in earnings?

A.3.a. Net realized and unrealized losses on derivatives and hedging activities were approximately $138 million in the second quarter of 2003, $111 million higher than in the first quarter of 2003. Because those losses flow through the income statement, they affect the level of reported net income. Those losses, therefore, contributed to the overall drop in reported FHLBank earnings in the second quarter. However, two points warrant elaboration. First, the drop in overall earnings to approximately 0.2 percent of assets was not as steep as the question suggests. The return on average assets for the FHLBanks ranged from 0.25 percent to 0.47 percent for the 1988–2002 period. It is not "generally around 1 percent." Second, in isolation, the realized and unrealized gain or loss on derivatives and hedging activities offers an incomplete picture of an institution's hedging activities.

When a financial institution reports a "loss" on derivatives and hedging activities, the loss often arises because accounting rules prohibit the recognition in income of simultaneous gains on the balance sheet items being hedged. For example, losses or gains on derivatives used to hedge the risks associated with held-to-maturity securities flow through the income statement. Under generally accepted accounting practices (GAAP), however, fluctuations in the value of the held-to-maturity assets being hedged with those derivatives are not recognized in income unless the fluctuation in value is deemed to reflect "other than temporary" impairment. In other words, an institution's GAAP income may be affected by the

[7] Those appointed to EIC positions are senior bank examiners, all of whom had extensive experience at other financial institution regulatory agencies before joining the Finance Board.

asymmetry of accounting rules that require the marking to market of the derivative, but not the held-to-maturity assets being hedged.

In the case of "securities held at fair value," changes in their market value appear on the income statement as an "unrecognized gain or loss on securities held at fair value." To the extent derivatives are used to hedge against changes in the market value of securities held at fair value, the income-statement categories "unrealized gain or loss on securities held at fair value" and realized or unrealized "gains or losses on derivatives and hedging activities" tend to move in opposite directions.

Consequently, a given change in interest rates will tend to generate gains on one set of instrument and losses on the other. To gauge the overall effect, one must consider the net effect of the change in value of the derivatives and of the securities held at fair value. The following table provides that information for the FHLBanks during the second quarter and the first half of 2003.

Income Statement Category	Second Quarter 2003 Results ($ Millions)	First Half 2003 Results ($ Millions)
Net Realized & Unrealized Gain (Loss) on Derivatives and Hedging Activities	(138)	(165)
Unrealized Gain (Loss) on Securities held at Fair Value	154	134
Net of the Preceding Two Items	16	(31)
Income before Assessments for AHP and REFCORP	613	1,234

For the second quarter of 2003, the combined effect of gains/losses on derivatives and the unrealized gain/loss on securities held at fair value was to contribute $16 million to income before REFCORP and AHP assessments of $613 million. For the first half of 2003, the combined effect of gains/losses on derivatives and the unrealized gain/loss on securities held at fair value was to decrease income before REFCORP and AHP assessments by $31 million resulting in a total of $1.2 billion. In each case, the net effect was less than 3 percent of income before assessments for REFCORP and AHP.

Thus, in isolation, the gain or loss on derivatives and hedging activities offer an incomplete picture of the effectiveness of an institution's hedging strategies. As bank supervisors, we are principally concerned with whether an FHLBank has a well conceived, properly documented, and prudently implemented hedging program that is designed to limit or reduce risk and that is subject to rigorous internal controls and oversight.

Q.3.b. How can we be sure that the Home Loan Banks are using derivatives to hedge risk instead of to speculate?

A.3.b. At June 30, 2003, the FHLBanks had notional derivatives of $693.8 billion. The total net exposure at fair value was $2.2 billion.

A focus of our supervisory policy, on-site examinations, and off-site monitoring is to review FHLBank derivatives activities for compliance with our rule prohibiting their use for speculative purposes. The following factors mitigate against the speculative use of derivatives by the FHLBanks.

- Finance Board rules specifically require that all derivative transactions must either qualify as hedging instruments pursuant to generally accepted accounting principles in the United States (GAAP) or the FHLBank must demonstrate the nonspeculative use (*See* 12 CFR § 956.6).
- All derivative contracts with a single counterparty must be governed by a single master agreement to facilitate the netting of obligations, such as International Swaps and Derivatives Association (ISDA) agreements.
- Finance Board rules require that all derivative contracts be marked to market and subsequent collateral adjustments occur no less frequently than monthly.
- The Finance Board receives information on the derivatives of the FHLBanks through monthly and quarterly sections of the call report.
- A critical element of the on-site examination of each FHLBank is a review of the policies and procedures dealing with derivatives, as well as a review of the internal controls, documentation, accounting, board of director oversight, and segregation of duties dealing with derivatives transactions.
- Each year as part of its annual audit, each FHLBank undergoes a review of the accounting for its derivative instruments by the FHLBank's independent external auditor.

Appropriate risk limits at the individual FHLBanks are a critical factor in controlling the use of derivatives for speculative purposes. Some of these limits are regulatory, for example, limits on duration of equity contained in the Finance Board's Financial Management Policy. Other limits are properly adopted and monitored by the FHLBank itself, subject to asset-liability committee and board of director approval. Duration of equity and value at risk, as well as other measures, such as market-value sensitivity to a variety of risk measures, are effective ways to assess the extent to which derivatives hedge risk exposure. The Finance Board regularly reviews compliance with both regulatory and internal risk limits as part of annual, on-site examinations.

The Finance Board examiners also assess whether the FHLBanks have appropriate policies, procedures, and controls in place regarding their use of derivatives at the instrument level. Key elements of such policies, procedures, and controls include a process for developing and approving hedging strategies and controls over implementation of those strategies. We expect those controls to include risk limits, identification of individuals within the FHLBank approved to conduct a trade, requirements for documenting hedge transactions, including risk analytics showing the specific risk exposure(s) reduced by the trade, and procedures to be followed if ever risk limits are violated.

The aforementioned steps limit the likelihood of unauthorized use of derivatives by any FHLBank. Nevertheless, a number of Finance Board initiatives should provide additional transparency and enhance oversight of FHLBank derivative activity. For example, the Finance Board has requested proposals for purposes of acquiring an Enterprise Risk Management system to enhance further our supervision of the FHLBanks. This sophisticated computerized asset-liability management software should enable the Finance

Board to generate a "second opinion" of risk exposure calculations generated by the FHLBanks, to compare risk exposures of the FHLBanks using a common set of methodologies and assumptions, and to measure additional risk exposures as the need arises. In the coming months, the Finance Board also expects to issue further guidance regarding market-risk management information that will be reported to the Finance Board for supervisory and monitoring purposes, providing additional information on the risk implications of derivative investments in a whole-portfolio context.

Q.4. It is my understanding that the Chicago and Pittsburgh FHLBanks impose a zero percent capital charge against mortgages acquired under their mortgage acquisition programs. However, they are required to maintain a minimum 4 percent total capital against assets. Given the fact that the Chicago FHLBank holds over $39 billion in mortgage assets, and only $25 billion in advances, can you please explain how the Chicago FHLBank is meeting its minimum capital requirements? Similarly, Pittsburgh holds $9.8 billion, nearly 20 percent, of its assets in mortgages. How does it meet its minimum capital requirements?

A.4. Prior to the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), member stock purchase requirements were uniform across the FHLBanks. Each member had to purchase subscription stock in its FHLBank that was at least as great as the larger of either (1) $500; (2) 1 percent of the member's aggregate unpaid loan principal;[8] or (3) 5 percent of the member's aggregate amount of outstanding advances.

With the passage of GLBA and its requirement that the FHLBanks convert to a risk-based, permanent capital structure, the FHLBanks were granted authority, subject to Finance Board approval, to develop their own stock purchase requirements for their members. Irrespective of how stock purchases requirements are defined, the FHLBanks are required to maintain a minimum of 4 percent total capital against assets.

The Finance Board approved all of the FHLBanks' new capital plans in 2002. To date, 6 of the 12 FHLBanks have implemented their revised capital plans (Seattle, Indianapolis, Pittsburgh, Cincinnati, Dallas, and Des Moines). The remaining 6 FHLBanks are expected to implement their new capital plans by the end of 2005.

Under the new capital plans, the FHLBanks impose on their members stock purchase requirements that are dependent on either the member's size, for example, measured by total assets, mortgage assets, or borrowing capacity, or on the level of business activity that member has with the FHLBank. In fact, all FHLBanks use member-based stock purchase requirements; all also use activity-based requirements for at least one or more activities. In cases where the FHLBanks impose a zero percent stock purchase requirement for a given activity, capital to support the assets acquired by the FHLBank because of that activity must come either from the membership stock purchase requirement, or other

[8] "Aggregate unpaid loan principal" means the aggregate unpaid principal of a subscriber's or member's home mortgage loans, home-purchase contracts and similar obligations. (*See* 12 CFR § 925.1).

outstanding stock, such as stock dividends or member voluntary stock purchases.[9]

All capital stock held by members, regardless of how it is obtained, is subject to the same waiting period once it notifies the FHLBank of its desire to redeem stock:

- 6 months after a member has given notice of its intention to redeem stock under the pre-GLBA capital plans, and for Class A stock under the GLBA capital plans;
- 5 years after a member has given notice of its intention to redeem stock for Class B stock issued under the GLBA capital plans.

Stock supporting a member activity may not be redeemed until that activity has been completed. Further, no FHLBank may redeem capital stock if doing so would result in that FHLBank's failure to meet minimum capital standards. Thus, it makes little difference whether the FHLBank is using membership, activity-based, or voluntary stock to meet its capital requirement supporting its assets, since the degree of permanence is not related to how the stock is acquired.

As the accompanying table indicates, the FHLBank of Chicago had total capital stock of $3.3 billion as of December 31, 2002. Of this amount, capital stock requirements assessed on the members of the FHLBank accounted for 45.2 percent of total capital, while voluntary stock holdings accounted for 49.1 percent. Retained earnings were 5.8 percent of the FHLBank's total capital.

The table similarly illustrates how the FHLBank of Pittsburgh capitalized its operations. As of December 31, 2002, total capital stock was $1.9 billion. Of this, 91.1 percent came from stock requirements assessed on members, 5.4 percent came from voluntary stock holdings, and 3.5 percent came from retained earnings.

[9] The Home Loan Bank Act allows members to voluntarily acquire "excess stock," for example, stock that is not required to be purchased by membership requirements or activity-based requirements.

FHLBank	Total Capital (Capital Stock Outstanding + Retained Earnings) ($Thousands)	Percent from Class A Stock, Or Still on Pre-GLBA Capital Plan	Percent from Class B Stock	Percent from Retained Earnings	Percent from Required Stock Purchases	Percent from Voluntary/Excess Stock Holdings	Percent of Capital Stock Outstanding Owned by Members w/Assets < $500 million	Percent of Advances by Members w/Assets < $500 million	Percent of MPF/MPP by Members w/Assets < $500 million
System	36,377			3.3%	76.1 %	20.7%	15.6%	10.8%	13.3% (MPF+MPP)
Boston	2,323	Pre-GLBA		1.9	89.5	8.6	19.6	18.2	76.1
New York	4,296	Pre-GLBA		5.7	80.7	13.6	4.9	2.9	34.1
Pittsburgh	1,906	0	100	3.5	91.1	5.4	14.3	12.2	0.8
Atlanta	4,726	Pre-GLBA		4.9	93.4	1.8	14.2	9.3	3.9
Cincinnati	3,611	0	100	1.7	63.4	34.9	16.6	11.2	17.3 (MPP)
Indianapolis	2,004	0	100	2.4	88.8	8.8	18.1	14.0	6.2 (MPF+MPP)
Chicago	3,317	Pre-GLBA		5.8	45.2	49.1	33.9	19.5	32.7
Des Moines	1,908	0	100	2.6	70.3	27.1	30.7	28.1	0.9
Dallas	2,548	0	100	3.0	68.1	28.5	21.0	14.4	36.1
Topeka	1,669	Pre-GLBA		2.3	79.5	18.2	23.9	17.8	13.7
San Francisco	5,687	Pre-GLBA		1.8	78.2	20.6	2.9	2.7	36.3
Seattle	2,382	0	100	1.6	66.8	31.6	13.0	12.9	0.2 (MPP)

Data as of 12/31/02; capital plan implementation dates as of 10/8/03.

Q.5. As I understand it, one result of treating Shared Funding interests as "acquired member assets" under the AMA rule is that such assets are not subject to the FHFB's requirement that MBS investments not exceed 300 percent of capital. Please indicate to what extent the Chicago FHLBank's investments in Shared Funding interests, combined with its other MBS investments, exceed this [three times capital] cap?

A.5. The Chicago FHLBank has not exceeded the three times capital limit on MBS investments.

As of August 31, 2003, the FHLBank of Chicago had $4.2 billion in mortgage-backed securities, $682 million in Shared Funding assets, and capital of $4.3 billion. As such, the total of mortgage backed securities and Shared Funding assets was approximately 112 percent of capital.

As a general matter, the FHLBank of Chicago has not substantially increased its investment in mortgage-backed securities over the last few years even though capital has increased substantially. The quarterly average of mortgage-backed securities reached its highest dollar amount in the fourth quarter of 2002 at $4.8 billion when average capital was $3.3 billion. The ratio of mortgage-backed securities to capital, based on annual averages from 2000 to 2002, fell from 271 percent in 2000, to 206 percent in 2001 and to 150 percent in 2002.

Q.6. Was the Finance Board aware of the problems in the manufactured housing portfolio at the New York Home Loan Bank before Standard & Poor's raised the alarm? Are you concerned about the potential for similar problems at other Banks?

A.6. During his regular monitoring of the FHLBank of New York in the first quarter of 2003, our examiner-in-charge (EIC) noted that the FHLBank had a concentration of securities backed by manufactured housing loans. The EIC, who, as an FDIC examiner had examined a large originator of manufactured housing loans, recognized the potential risk posed by the New York FHLBank's concentration of investment securities backed by manufactured housing loans and home equity lines of credit. Because of that concern, the EIC alerted the FHLBank in March 2003 that this portfolio would be a specific area of review at the 2003 examination of the FHLBank. In particular, the EIC notified the FHLBank that we would be reviewing the assumptions of values, and potential for credit losses in manufactured housing-backed securities.

Standard & Poor's reduced the outlook for the FHLBank of New York to negative from stable in August 2003, well after the EIC had first alerted the FHLBank of his concerns.

While we are monitoring the investment portfolios of all of the FHLBanks, we are not concerned about the potential for similar problems with respect to manufactured housing securities at other FHLBanks. According to our quarterly call report data, no other FHLBank has any significant holdings of these securities.

Q.7. Earlier this year, Fannie Mae and Freddie Mac agreed to provide MBS investors with additional information about their mortgage backed securities, including such things as original loan-to-value ratios, credit scores, property types, and others. What dis-

closures are made to investors in the certificates issued under the Shared Funding Program?

A.7. The three investors in the certificates of the initial shared funding transaction are the FHLBanks of Des Moines, Pittsburgh, and Chicago. Under Securities and Exchange Commission (SEC) rules, they are qualified investors.

Under the Shared Funding Program, the underwriters of the securities provide the disclosures to investors in the certificates of the mortgage-backed securities in a confidential Private Placement Memorandum and a Private Placement Supplement (collectively, the "Memorandum"). These disclosures are governed by standards for private placement securities as established by the SEC.

During an examination of an FHLBank, we reviewed that Memorandum, which the FHLBank had received as an investor in those securities. The Memorandum includes detailed information on the mortgage pool. For example, information is provided on credit score distribution, loan-to-value ratios, geographic distribution of the mortgaged properties, loan purposes, property types, and documentation types. In addition, information is provided on the risks associated with investing in these securities, for example, risk of loss. Without opining as to the legal sufficiency of the Memorandum, our examiners concluded that the Memorandum was comprehensive both as to the characteristics of the underlying assets and the risks to an investor.

Q.8. Dow Jones reported last month that total Federal Home Loan Bank operating expenses for the second quarter of 2003 were 17.5 percent higher than operating expenses for the same period last year ("FHLBanks Report Significant Boost in Operating Expenses," August 15, 2003). Can you explain why operating expenses have increased so dramatically?

A.8. The increase in operating expenses from the second quarter of 2002 to the second quarter 2003 reflects the 13.3 percent growth in System assets during this same period. Assuming that operating expenses represent a constant proportion of assets, this growth would account for more than three-quarters of the increase in operating expenses noted in the question above.

During this period, however, the FHLBanks also began to acquire significant holdings of mortgages under the Mortgage Purchase and Mortgage Partnership Finance® programs, with the value of combined program assets increasing by 135 percent between the second quarter of 2002 and the second quarter of 2003. This growth pushed the value of such assets to more than 11 percent of total System assets from 5.4 percent at the beginning of the period. Because this represents a relatively new line of business for FHLBanks and because the risks posed by this business are more complex than those posed by the Banks' traditional advance products, the Finance Board expects that FHLBank operating expenses will increase at a faster rate than aggregate assets until the appropriate risk-management programs emerge.

A comparison between publicly available Fannie Mae and Freddie Mac data underscores this expectation. While FHLBank System annualized administrative operating expenses represent 5.7 basis points of combined assets, Fannie Mae (2002) and Freddie

Mac (2001 is the most recent data available) reported administrative operating expenses of 13.7 basis points of assets. Furthermore, both these institutions reported year-on-year growth in operating expenses approaching 20 percent, a result of expenses related to development of updated IT infrastructures and salaries.

Past levels of FHLBank funding for risk management have not been sufficient to manage their increasingly complex balance sheets. FHLBank operating expenses can be expected to increase at a faster rate than aggregate assets until enhanced risk-management programs are in place. The Finance Board has been recommending that the FHLBanks bolster their investments in risk management infrastructures and their expenditures on resources to create and maintain these investments. To measure their success in doing so, Finance Board examinations and off-site monitoring will look closely at whether FHLBank outlays are sufficient for, and sufficiently directed toward, the creation and maintenance of sound risk-management infrastructures.

Q.9. Does the Finance Board collect information on the Home Loan Banks' affordable lending and community development activities? Is that information considered in your review of the Banks' compliance with their mission?

A.9. The Finance Board collects information on the Banks' affordable lending and community development activities for four different mission-related activities of the FHLBanks:

- The Affordable Housing Program (AHP);
- The Community Investment Program (CIP);
- Community Investment Cash Advances (CICA); and
- Acquired Member Assets (AMA).

Congress established the AHP and CIP in 1989 as mission-specific programs to assist in the financing of affordable housing and community development projects for targeted income levels. The AHP provides funding solely for affordable housing for very low, and low- and moderate-income households. The CIP is used for advances to members to fund both affordable housing for targeted households and community development benefiting low- and moderate-income households. All 12 FHLBanks are required to provide funding through them. CICA is a regulatory program, implemented in 1999, for financing community development for which CIP is not well-suited and is targeted according to household income, geographic areas, such as brownfields or small business eligibility. FHLBank participation in CICA programs is voluntary. The AMA program, as adopted by the Finance Board in July 2000, allows an FHLBank to acquire eligible whole residential mortgage loans, or interests in such loans, from its members. The Finance Board collects loan level data on all mortgages acquired by the FHLBanks under the AMA program, including data on property location and borrower characteristics.

These four programs—AHP, CIP, CICA and AMA—are important, but not exclusive, components of the FHLBanks' overall activities and operations designed to meet their public policy mission. The AHP, CIP, and CICA programs are targeted programs that complement the FHLBanks significantly larger advances operations that support their financial institution members in meeting

the housing and community development needs of their service areas.

The Finance Board uses the data collected for AHP, CIP, and CICA to monitor and evaluate the activity levels of these programs at individual FHLBanks and for the entire System; to assess the FHLBanks' compliance with the statutory and regulatory requirements of these programs; and to evaluate and develop policies affecting the operation of these programs. The Finance Board also uses the AHP data specifically to ensure that all the FHLBanks contribute the full amount of the required AHP contributions (ten percent of net earnings each year) and that these amounts are distributed to eligible projects. The Finance Board also uses CICA data to evaluate the distribution of community development funding among the various targeted purposes.

The Finance Board uses AMA data primarily for the assessment of the safety and soundness of the FHLBanks mortgage portfolios and to determine compliance with regulatory requirements.

Since 1990, the FHLBanks have made more than $1.8 billion available for affordable housing through the AHP; $27.9 billion for affordable housing through the CIP; and $4.5 billion for targeted community development projects through the CIP and CICA.

During the past year, the Office of Supervision implemented a horizontal review of all 12 FHLBanks' Affordable Housing Programs. This review was comprised of a series of on-site interviews with the FHLBanks' community investment staff, senior managers, and directors, along with an examination of the documents supporting the program. We are currently analyzing the results of this review. Our analysis will result in a report to be presented to the FHLBanks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM SHELIA C. BAIR

Q.1. What is your assessment of the quality of the FHFB's safety and soundness supervisory program as compared to the major bank regulatory agencies? As compared to OFHEO? What do you view as the primary weaknesses in the FHFB's safety and soundness regulatory regime?

A.1. The FHFB does not publicly disclose as detailed information about its safety and soundness supervisory program as do the major bank regulators. Thus, comparisons are difficult to make. A 1998 Report by the GAO[1] identified several deficiencies in the FHFB's examination program which FHFB officials then attributed, at least in part, to a shortage of qualified examination staff. At the time of that GAO report, the FHFB had only 10 examiners. By late July 2002, the FHFB still had only 10 examiners.[2] The current FHFB has placed greater emphasis on safety and soundness, and according to recent public statements by Chairman John Korsmo, the number of examiners has been increased to 17. The

[1] General Accounting Office. 1998. Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight. September. (GAO/GGD–98–203).

[2] General Accounting Office. 2003. Financial Regulation: Review of Selected Operations of the Federal Housing Finance Board. February. (GAO–03–364).

FHFB hopes to increase that number to 24 by the end of this calendar year and 30 by the end of the next fiscal year.[3]

The number of examiners employed by the FHFB—though on the rise—still pales in comparison to the large, experienced examination staffs of the major bank regulatory agencies. For instance, OCC will have 20 to 30 examiners assigned in residence to *each* of its largest institutions, in addition to special teams that may visit the institution as part of the annual examination process. Similarly, the FDIC and OTS—while not utilizing in-residence examiners—will assign teams of 20 to 30 examiners for extended periods to review their larger institutions. For an institution the size of Washington Mutual, for instance, the size of the team can go as high as 50 examiners. OFHEO also has significantly more examiners, a total of 40, who conduct annual examinations and ongoing monitoring of Fannie Mae and Freddie Mac.

The FHFB and OFHEO do not disclose detailed operating budgets. Thus, it is difficult to compare the amount of resources they devote to their supervisory programs. OFHEO's 2002 annual report to Congress indicated that it spent just 16 percent of its budget on examinations. However, because OFHEO conducts capital adequacy reviews separately from the examination process, that number may understate the resources it commits to supervision. An additional 13 percent of the Agency's budget is reportedly devoted to capital adequacy.

According to the 2003 GAO report $9.7 million of FHFB's $27 million budget was devoted to the Office of Supervision (OS),[4] or 36 percent. However, that figure may overstate the amount actually spent on examinations because the OS is also responsible for providing policy advice and analysis and reporting on general economic, housing, finance, community investment, and competitive environments for the FHLBanks.

In contrast, the Office ofthe Comptroller of the Currency (OCC) spends 85 percent of its budget on its supervision program, the bulk of which goes to salary and benefits for its 1,882 examiners. Similarly, the Office of Thrift Supervision (OTS) spends 77 percent of its budget on its supervision program, mostly supporting its 526 safety and soundness exammers.

Both OFHEO and the FHFB lack formal training and accreditation programs for their examiners. In contrast, all the major bank regulators have training and accreditation programs, and the overwhelming majority of their examiners are either accredited or in training to become accredited.

It should be emphasized that the FHFB and OFHEO have a number of experienced, knowledgeable examiners dedicated to conducting rigorous oversight of institutions under their authority. However, the size and the depth of experience of these agencies' examination staffs do not compare favorably to that of the bank regulators. Both agencies are no doubt impeded in their ability to attract highly qualified staff given their small size and narrow regulatory base, which in turn, limits the opportunities for promotion and career advancement.

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[3] Testimony of John Korsmo before the Subcommittee on Financial Institutions, Senate Banking Committee (September 9, 2003).

[4] *Ibid.* pgs.10 and 28.

Q.2. How would the FHFB's recently withdrawn proposed AMA rulemaking have affected safety and soundness oversight of the FHLBanks? In your view, is the Chicago FHLBank's Shared Funding Program consistent with the current AMA rule?

A.2. Chairman Korsmo's stated intent behind the recently withdrawn AMA rulemaking was to "to clarify and simplify the current rule, while improving oversight." I have no doubt that the Chairman and FHFB members believed the proposed changes were consistent with safety and soundness. However, the impact of many of the proposed changes would have been to ease important safety and soundness restrictions currently in place over the FHLBanks mortgage acquisition programs. The most dangerous of the proposals was to eliminate the requirement that acquired mortgage assets receive an investment grade rating from an independent agency such as Moody's or Standard & Poor's, instead allowing the FHLBanks to use their own "estimated credit ratings." Another would have eased credit enhancement requirements, and diluted restrictions on the types of collateral that a member must post to secure its credit obligations under AMA. The proposed changes would also have allowed FHLBanks to purchase "interests" in whole loans, for example, securitizations, in contrast to the current requirement that they must purchase whole loans. Finally, the proposed rulemaking would have opened the door to allowing System members to act as conduits for participation in AMA by nonmember finance companies and mortgage bankers.

It does not appear that Chicago's Shared Funding Program is consistent with the current AMA rule, which, as mentioned above, is restricted to purchases in "whole loans." The FHFB staff quietly approved the Shared Funding Program last December, with no public discussion or input. Under the program, Mortgage Partnership Finance (MPF) loans are sold to a member of the Chicago FHLBank, which issues its own "private label" securities backed by these loans. Two tranches of securities are created, with the senior tier being sold to the Chicago FHLBank or other FHLBanks, which may in turn, sell some or all of the securities to System members. The member securitizing the loans may sell the securities or "certificates" anywhere in the capital markets or hold them in portfolio. Shared funding provides a vehicle for the Chicago FHLBank to circumvent charter limitations on its own issuance of MBS by partnering with one of its member institutions.

As previously mentioned, the FHFB' s current AMA rule authorizes the FHLBanks to purchase from members only "whole loans" based on the rationale that such purchases are the "functional equivalent of an advance" to such members. However, Shared Funding Certificates are clearly "interests" in whole loans. Presumably, one of the reasons the FHFB sought to extend the AMA to "interests" in whole loans was to reconcile the current inconsistency between the Shared Funding Program and FHFB regulatory requirements.

The FHFB has also exempted Shared Funding Certificates from the limit FHLBanks otherwise must observe for investing in mortgage-backed securities: Three times capital. The Treasury Department has previously expressed the view that MBS investments are a way for the FHLBanks to generate arbitrage income, though they

provide little public benefit. Similarly, MBS acquired through the Shared Funding Program, while adding interest rate and credit risk to the books of the FHLBanks, would appear to add no new value.

These issues and others are discussed in more detail in a comment letter Greg Baer and I filed on the proposed AMA rulemaking, which is attached. Mr. Baer preceded me as the Assistant Secretary for Financial Institutions in the Clinton Administration.

Q.3. The Pittsburgh FHLBank suffered a very bad second quarter. Based on its most recent financial reports, its annualized return on assets is .02 percent. Its capital stands at $2.25 billion, or 4.2 percent of assets, barely above the regulatory minimum. Its second quarter dividend was subsidized with $10 million from retained earnings. In your opinion, would a bank regulator allow a bank to pay a dividend if the bank's core operating results were so poor? What types of supervisory action might be taken by a bank regulator when confronted with a bank in this type of financial condition? Based on your research, when will a bank regulator intervene based on a bank's deteriorating capital position? Does the regulator wait until the minimum requirement is breached before taking supervisory steps?

A.3. Federally regulated banks and thrifts generally hold on average at least 50 percent more capital than the regulatory minimum. If they fall below a sufficient capital level, or if there are other indicators of financial deterioration, Federal examiners will carefully scrutinize their financial position, request a capital restoration plan and direct corrective action if there are indications of further financial deterioration. Federal bank regulators try to identify early "red flags" of financial troubles and institute corrective action long before there is a threat that minimum capital will be breached.

Federal bank regulators look at several factors when determining the appropriate supervisory action to take. In determining a bank's financial condition, they perform an in depth analysis of earnings to assess their quality, level, and trends. They will seek to identify the source and cause of earnings issues before making a determination of their severity and the degree of supervisory concern warranted. In determining the adequacy of a bank's capital, bank regulators will evaluate the quality of the bank's assets, interest rate sensitivity, and risk management practices. Before a final determination concerning the bank's capital level could be fully implemented, they would want to know the bank's availability of other capital sources and if there were any plans to use those sources. They would also evaluate the possible adverse impacts of the bank not paying a dividend before taking action to prohibit such payment.

If the Pittsburgh FHLBank had been regulated by one of the Federal bank regulators, I believe it very likely that bank examiners would have taken action to restrict or prohibit dividend payments, and most certainly would not have permitted a dividend payment that had to be subsidized with retained earnings. (For example, Federal law 12 U.S.C. 56 and 60 restricts the payment of dividends by national banks; other bank charter types are subject

to similar restrictions.) Rather, Federal bank examiners likely would have acted to restrict asset growth, while protecting capital to cushion against further losses, and taken action to address any underlying unsafe and unsound practices that caused or contributed to the bank's undercapitalized condition, including restricting the bank's ability to enter into new contracts or engaging in new business lines. This would be particularly true if the earnings problems were associated with exponential growth in a new, higher-risk activity and were expected to persist, which is the case in Pittsburgh. The Pittsburgh FHLBank grew MPF loans from about $2 billion at June 30, 2002 to over $9 billion at June 30, 2003 and is predicting protracted constraints on earnings arising from losses associated with prepayments on its mortgage portfolio. And of course, the Pittsburgh Bank just announced that it is now estimating a third quarter GAAP net *loss* of $6.5 million.

Comparison of Examination Processes and Funding

Safety & Soundness Examination Staff

	Total # of Examiners	Total Assets of Regulated Institutions	Avg. Years of Examiner Experience	Examiner Accreditation Required	% of Examiners Accredited
OFHEO	40	$1.6 trillion	N/A	No	N/A
FDIC	1,755	$1.7 trillion (a)	15.1 years	Yes	95%
FHFB	17 (b)	$763.6 billion	N/A	N/A	N/A
FRB	1,234	$1.9/$8.2 trillion (c)	13.7 yrs.	Yes	72%
OCC	1,882	$3.9 trillion	14 yrs.	Yes	70%
OTS	526	$1.4 /$5.3 trillion (d)	19.3 yrs.	Yes	95%

(a) The FDIC has backup examination and enforcement authority for all its insured institutions, whose combined assets totaled approximately $9 trillion at mid-2003.
(b) As of September 2003. Plan to increase to 30 examiners by end of FY 2004.
(c) The first number is for FRB regulated, state chartered banks, the second for financial holding companies.
(d) The first number is for OTS regulated thrifts, the second for thrift holding companies.

Examination Funding

	% of Budget Spent on Examinations	Self-funded
OFHEO	16%(a)	No
FHFB	36% (b)	Yes
OCC	85%	Yes
OTS	77%	Yes

(a) Unlike the bank regulators, OFHEO conducts capital review separately from the examination process. An additional 13% of the agency's budget is allocated to capital.
(b) Based on total budget for the Office of Supervision, which also conducts policy analysis and market research. Actual percentage is likely to be lower.

(ATTACHMENT/ BAIR RESPONSES TO QUESTIONS OF SENATOR SARBANES SEPTEMBER 9 HEARING ON FEDERAL HOME LOAN BANK SYSTEM)

September 2, 2003

Federal Housing Finance Board
1777 F Street, N.W.
Washington, DC 20006

Attn: Public Comments

TO: The Federal Housing Finance Board

RE: Proposed Rule 2003-10

We are writing to voice our concerns about the Finance Board's proposed rule on Acquired Member Assets. The Finance Board announced on August 20 its intention to withdraw the proposed rule at its September 10 meeting, but reissue the proposal at some subsequent time. We believe that the proposed rule should not be re-issued. As recent revelations at the FHLBank of New York underscore, the Finance Board's priorities at this time should be strengthening its safety and soundness oversight of the FHLBanks, consistent with recommendations of the General Accounting Office, and improving the FHLBanks' public financial disclosures, not expanding the FHLBanks' ability to enter into high risk activities that have not been authorized by Congress. The proposed rule, and the profound changes it would make to the Federal Home Loan Bank System, are contrary to both the letter and spirit of the Federal Home Loan Bank Act. The proposed rule would effectively end the System's Congressionally enacted status as a member owned cooperative. It would also allow the System to engage in activities carrying substantial risk, without the statutory safety and soundness protections that apply to the System's statutorily authorized advance business.

The proposed rule repudiates completely and without explanation the legal and policy basis for the AMA announced by the Finance Board as recently as its 2000 final rule. The Finance Board stated in adopting the AMA rule:

> Part 955 of the final rule addresses AMA -- that is, whole loans and certain interests in whole loans that a Bank may acquire from or through its members or housing associates in *a transaction that is in purpose and economic substance functionally equally to the business of making advances* in that: (1) *It allows the member or housing associate to use its eligible assets to access liquidity for further mission-related lending*; and (2) *all, or a material portion of the credit risk attached to the assets is being borne by the member or housing associate.*

65 Fed. Reg. 43,969, 43,974 (July 17, 2000). In marked contrast, the current proposed rule states without elaboration that "the underlying purpose of the AMA rule . . . is *to allow a Bank to acquire a high-quality asset from or through its members* and housing associates by transactions that support its statutory housing finance mission."[1] Thus, the announced purpose of AMA has shifted from the FHLBanks assisting their members by supplying liquidity to the FHLBanks' acquiring assets for *themselves*, with the member retaining practically no risk. As described below, the operations of the proposed rule are consistent with this new, wholly inappropriate, purpose for the System.

The most startling aspect of the Finance Board's notice of proposed rulemaking is its failure to engage, even acknowledge, these extremely significant legal and policy issues. We believe that the preamble to the proposed rule is misleading in numerous ways, and would fail to allow for informed public comment. If the Finance Board is inclined to republish the proposal along similar lines, it should at least include a full and candid discussion of the implications of the rule. In the absence of such a discussion, the public will be denied a fair opportunity to comment on a rule that will have fundamental impacts on the housing market and, potentially, the taxpayer.

Set forth below are comments on particular sections of the rule, following the general outline of the preamble.

Section 955.3 -- Defining AMA assets to include interests in whole loans

The proposed rule would treat "interests in whole loans" as authorized for purchase by the FHLBanks. The current AMA rule authorizes FHLBanks to purchase from members only "whole loans," on the grounds that such purchases are the "functional equivalent of an advance" to such members. However, when the FHLBank of Chicago expressed an interest in trading mortgage-backed securities, the Finance Board "interpreted" the reference to whole loans to include "interests" in whole loans as well, even though it had never sought comment on the subject. This interpretation was, and

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[1] 68 Fed. Reg. At 39,031. As the only support for this statement, the proposed rule cites, "See proposed AMA rule, 65 FR at 25681." No such support appears at that page, however, or elsewhere in the proposed rule. The purposes cited at page 25,681 are the same ones cited in the final rule: providing liquidity to members and allowing them to retain credit risk.

Furthermore, it is worth noting that the FHLBank Act does not prescribe any "housing finance mission" for the FHLBanks. The only reference to "housing finance mission" is in section 2A of the Act, which describes the duties of the *Finance Board*. 12 U.S.C. § 1422a(a)(3)(B). This section directs the Board -- as regulator -- "to ensure that the FHLBanks carry out their housing finance mission." The provision was added to the Act in 1989, and transferred from the defunct Federal Home Loan Bank Board to the new Finance Board authority over the FHLBanks, including their new AHP obligation. See H.R. 101-54 at 378, 454 (summarizing changes to section 2A of the Act as "definitional adjustments"); S. Rep. 101-19 at 5-6 (no mention of expansion in Bank powers). Indeed, when the Finance Board's issued its own implementing regulation, its summary of the effect of FIRREA included no claim that the statute had somehow expanded the Banks' powers.

remains, a clear violation of the Administrative Procedures Act. The proposed rule attempts to cure this defect.

We oppose extending AMA assets to include interests in whole loans. The proposed rule fails to describe the range of interests that might be included, but they presumably include mortgage-backed securities. The FHLBank Act grants the Banks no authority to trade in securities except pursuant to their investment authority under Section 11(h) of the Act. Trading securities is not an activity incidental to, or otherwise related to, advances. Any trading in securities should be subject to the statutory and regulatory limits imposed on Section 11(h) investments, including the 300% of capital cap on MBS investments contained in the Finance Board's Financial Management Policy.

Section 955.4 -- Repeal of the Member Origination and Valid Business Purpose Rules

The Finance Board proposes to repeal a significant "nexus requirement" that currently applies to AMA purchases: a requirement that loans purchased under AMA either be originated by a member or held by the member for a "valid business purpose."[2] As the preamble notes, this requirement "is intended to discourage the use of members as conduits for the sole purpose of passing mortgage loans from a nonmember to the Bank." 68 Fed. Reg. at 39028. Of broader significance, the nexus requirement is the only means by which the current AMA rule seeks to ensure that FHLBank asset purchases are used in order to provide liquidity to members. As noted above the Finance Board emphasized in adopting the AMA rule that its purpose was to "allow the member or housing associate to use its eligible assets to access liquidity for further mission-related lending" 65 Fed. Reg. at 43,974.

We strongly oppose repeal of the nexus requirement because it will inevitably lead to members being used as conduits to allow FHLBanks to fund lending by non-member mortgage banks and finance companies. Such funding violates both the letter and spirit of the FHLBank Act, which carefully limits the benefits of System membership to those whom Congress has permitted to join. Congress established the Federal Home Loan Bank System in order to provide liquidity to members making mortgage loans (and, later, other specified types of loans). Congress authorized advances to members, and the Finance Board has read that authority also to allow mortgage purchases from members. Obviously, the Congressional purpose is defeated, and the benefits of government sponsorship misused, if the loans purchased are not originated by members. Just as the FHLBank Act does not authorize advances to be made to finance companies, mortgage

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[2] The preamble begins the discussion of the rule by noting "Section 955.4 of the proposed rule would retain a nexus requirement by providing that a Bank may acquire AMA-eligible loans only from its members and housing associates, from members and housing associates of another Bank, or from another Bank." But the prohibition on Banks obtaining loans from non-members is not a Finance Board-imposed nexus requirement but a simple fact of statutory life, as the Banks are not authorized to transact with nonmembers.

banks, and other lenders, it certainly does not authorize "incidental" purchases from such entities.

Furthermore, extending System funding to non-members would be unfair to FHLBank members, particularly small bank members, who would have to compete with these "free riders." A further inequity arises from the fact that conduits are likely to be large mortgage-aggregating members. Congress imposed some burdens on members in exchange for access to FHLBank liquidity -- for example, purchase of FHLBank stock. While these burdens of membership are considerably outweighed in most cases by the benefits, they are nonetheless material. For the Finance Board and certain FHLBanks to extend the benefits, but not the burdens, of the System to non-member lenders would be unfair to System members with whom they compete.

We note that the preamble provides assurances that the proposed rule would not allow the use of members as conduits or feeders for FHLBanks seeking growth. The preamble introduces the proposed repeal of the nexus requirement by stating that "[t]he proposed elimination of this requirement is intended only to simplify the rule, and does not alter the underlying policy that AMA-eligible whole loans may be acquired only from members and housing associates."[3] We find this assurance difficult to credit, however, for two reasons.

First, in the next section of the proposed rule, the Finance Board seeks comment on whether to authorize purchases from affiliates of members -- an authorization not in the rule as proposed. The preamble notes that absent such an authorization, the proposed rule would mean that "a Bank could not purchase mortgage assets *directly* from an affiliate of a member, and any such assets *would have to be acquired by the member before a Bank could acquire them as AMA*." Id. (emphasis added). Here, there is no mention of a prohibition on using a member as a conduit. Although such purchases would be prohibited under the nexus requirement of the current rule, the preamble assumes that they would be permissible under the proposed rule.[4] The FHLBanks will read this language to allow the use of members as conduits for allowing FHLBank purchases of mortgage loans from their affiliates, and others.

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[3] Of course, this restates and misstates the underlying policy and legal basis of the AMA rule: the purpose is to fund greater mortgage lending by members by providing them liquidity. There is no "underlying policy" that AMA loans "may only be acquired from members and housing associates"; that is simply the law, and not related to the nexus requirement. If the proposed rule would indeed allow members to serve as conduits for their affiliates or other non-members, then the notice is fatally flawed.

[4] In a similar vein, the preamble notes that the proposal "would eliminate the requirement that AMA must be originated or issued by or through a member, housing associate or affiliate thereof." We do not understand the reference to "issued by or through" or to affiliates. It appears to evidence a reinterpretation of the current rule at odds with its plain language.

Second, as its primary basis for repealing the "valid business purpose" test, the Finance Board states the current rule has been difficult to enforce because "valid business purpose" is an undefined term. The proposed rule, however, fails to seek comment on whether a definition of "valid business purpose" might be appropriate. We could propose several: for example, "held pursuant to an acquisition or merger" or "held for at least 90 days." If the motivation for repealing the nexus requirement is truly the vagueness of the current standard, and not a desire to allow members to serve as conduits, then that concern can be readily resolved without extending the benefits of the System to non-members.

If the Finance Board intends to republish this proposal, we recommend that it: (1) explain the legal and policy basis of the existing nexus requirements; (2) explain the legal and policy results of their repeal; and (3) seek comment on alternatives to their repeal, including clarification of their meaning and intent.

Section 955.4 -- Acquisition of assets from affiliates of a member bank

The proposed rule requests comment on "whether, and under what conditions a Bank may be permitted to acquire AMA qualifying assets from an affiliate of a member." The FHLBanks simply have no legal authority to acquire AMA qualifying assets from an affiliate of a member. Affiliates of members are granted no special status by the FHLBank Act -- indeed, are not mentioned. They are thus in the same position as other non-members. A FHLBank has no greater authority to buy loans from an affiliate of a nonmember than it does to make advances to an affiliate of a member -- that is, none.[5]

Section 955.5(a) Required Credit Risk-Sharing Structure

Adequacy of Notice. As described below, the proposed rule would make significant changes to the risk-sharing structure of AMA, yet the preamble begins a discussion of this proposal by noting, "Proposed § 955.5(a)(1) would retain the current requirement that the Bank implement a credit-sharing structure for each AMA Product, under which a member or housing associate provides the credit enhancement necessary to enhance an asset or pool of assets acquired by the Bank to the equivalent of investment grade." This statement is extremely misleading. In fact, the proposal: (1) significantly changes, rather than retains, the existing credit-sharing structure; (2) no longer requires a member or housing associate to provide the credit enhancement -- indeed is expressly designed to allow a member to *avoid* retaining credit risk; and (3) changes significantly what constitutes "investment grade." While the preamble would assure a potential commenter that any changes are technical in nature, they are anything but. If the Finance

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[5] It is worth noting that the proposed rule deletes the current definition of "affiliate" and the section of the rule proposing to allow direct purchases from an affiliate does not make any reference to what definition "affiliate" might have for that purpose. Obviously, if the Finance Board envisions any definition different from the one in current use, it would need to seek comment on such a change.

Board should decide to republish this part of the proposal, we urge it to give commenters adequate notice of its legal basis and likely effect.

Satisfaction of credit enhancement standard. The proposed rule would eliminate the requirement that AMA assets, or pools of assets, achieve an investment grade rating from an NSRO like Moody's or Standard & Poors, instead allowing Banks to use their own "estimated credit ratings." This proposal is extremely unwise, and will inevitably lead to abuse. We urge the Finance Board not to republish it.

A FHLBank experiencing significant losses will have every incentive to continue self-rating its debt investment grade, thereby preserving its reputation. Recently, we have seen at the FHLBank of New York how even rated securities can diminish in credit quality, and that the Finance Board cannot be expected to notice such a decline. The failure of the FHLBanks to register their securities with the SEC, and thereby submit to the public disclosure requirements of the securities laws, further increases the importance of having an NSRO as an objective check on FHLBank risk taking. But for a report from Standard & Poor's, we suspect that the problems at the New York Bank may never have come to light. Eliminating the role of Standard & Poor's and other ratings agency seems exactly backwards in light of this recent experience and the proposal's substantial increase in risk for the System.

We note that the proposal includes no justification for removing the NSRO requirement. There is no claim, for example, that the requirement has been difficult or expensive to administer. Absent such a rationale, commenters might assume that the motivation is either to avoid independent scrutiny of the FHLBanks' loan quality, or to allow the FHLBanks to purchase non-investment grade assets. We believe that if the Finance Board republishes this proposal it should at least clarify its purpose.

Decline in estimated credit rating. Section 955.5(a)(4) of the proposed rule governs what occurs when an asset's "estimated credit rating" falls below investment grade. In such a case, the FHLBank is given the option of either seeking additional credit support from the member sufficient to increase the estimated credit rating back to investment grade, or holding additional capital against the higher exposure.

We simply do not understand this section of the rule. At the time of the sale of the assets, the recourse arrangements presumably will allocate risk among the FHLBank, the member, and a mortgage insurer. Such an arrangement will constitute a contractual agreement as to who bears losses, and would not ordinarily be affected by a downgrade in the quality of the asset. Section 955.5(a)(4) appears to assume that the FHLBank could subsequently decide unilaterally to alter that agreement by requiring the member to take on additional risk, or assuming that risk itself. We do not understand how such an arrangement could work.

The importance of the capital requirements is accentuated by the lack of any non-capital sanction for holding junk assets. The current rule creates a substantial impediment to a FHLBank holding a portfolio of junk bonds: an explicit requirement

that the Bank hold retained earnings against risks greater than those of an asset holding the second highest credit rating from an NSRO (e.g., AA from Standard & Poor's). The proposed rule eliminates this requirement. We suspect, given the inadequacy of the notice, that the effective capital requirement for junk AMA under the proposed rule is a fraction of what it is under the current rule.

If the Finance Board decides to republish the rule, we strongly urge it to give commenters adequate notice of the precise capital impact of FHLBanks holding non-investment grade securities or loans.

Credit Enhancement Requirements -- Proposed § 955.5(b)

The preamble states that the proposal "would retain the requirement in...the current rule that the credit enhancement must be provided by a member or housing associate of the Bank," and would "allow a Bank greater freedom to design specific AMA Products." 68 Fed. Reg. At 39,029. In fact, however, the proposed rule would do the opposite: allow the member to shed all but minor credit risk by transferring that risk either to the FHLBank or a mortgage insurer.

Economic cost; third party credit enhancement. The current rule requires that the member retain the first loss position, and that any insurance cover losses only after the member has taken losses on a credit enhancement that was sufficient to achieve an investment grade rating. This requirement was absolutely central to the Finance Board's legal justification and policy rationale for adopting the final rule in 2000:

> The Finance Board believes that the recourse model, under which the seller of a mortgage retains all or part of the credit risk, is a more economically efficient system for bringing the benefits of the capital markets to the mortgage industry. Under the recourse model, entities that underwrite the loans benefit from good underwriting and therefore are economically disciplined to reduce credit risk. In contrast to the insurance-based secondary market model, under which Fannie Mae and Freddie Mac are paid a premium to insure against credit losses, the recourse model allows an originator to take on more credit risk (so long as that risk is adequately capitalized) and to profit from successful management of that credit risk. Thus, credit risk is dispersed among the many potential originators in the Bank System, and even further dispersed through the permitted insurance and credit derivative structures.
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> In general, [the AMA rule] enables the Bank and the member to take best advantage of their core competencies by: (1) requiring the member to bear most of the economic cost and the management burden associated with lowering the credit risk of AMA assets to levels comparable with investment grade rates securities; thus (2) leaving the Bank with AMA assets that have a risk profile similar to the securities that have historically been a normal part of Bank operations.

65 Fed. Reg. at 43975

As we read it, the proposed rule would allow a FHLBank to hold substantial credit risk, and the originating member practically none. The proposed rule would eliminate the current requirement that a third party cover only those losses that remain after the member has borne expected losses. For a FHLBank to purchase an AMA asset, the Bank need only receive an assurance from the member/originator that the asset is investment grade at the time of sale. For its part, the member may transfer any or all of its risk to a mortgage insurer, and limited risk to a pool insurer. This arrangement shares no economic features with a traditional advance -- the statutorily authorized activity of the System -- where a member holds credit risk funded by its FHLBank. It also represents an explicit repudiation of the Finance Board's original adoption of a "recourse model" in favor of its previously disparaged "insured-based" model.

It is passing strange that Finance Board has proposed to eliminate such a critical part of its rule without any meaningful notice or discussion. To the extent that the existing rule was legally valid, it must have been based on a theory that the retention of credit risk with the member made AMA the functional equivalent of an advance, and therefore an "incidental" activity. The proposed changes destroy that notion.

Remarkably, the section of the preamble discussing these changes concludes, "This approach is not intended to alter the economics of the current risk-sharing requirement." We simply cannot understand the factual basis for such a statement.

If the Finance Board should decide to republish the rule, we urge it to explain the legal and policy basis for this sea change in its approach.

Direct obligations of members. Under the proposed rule, members must continue to post collateral to support any credit obligation they make to a FHLBank, using collateral eligible to secure advances. The Finance Board seeks comment on whether to allow a member to use any type of collateral to secure its credit enhancement obligations. The notice fails to proffer any justification for such a step.

As a legal matter, Congress was quite strict in specifying the types of collateral that may be used to secure advances. Congress wished to be sure that the Banks had high quality collateral when they exposed themselves to credit risk from their members. Now, having justified AMA purchases, and the associated credit risk, as the functional equivalent of, or incidental to, an advance, the Finance Board implicitly asserts the authority to leave these credit exposures collateralized in any way it sees fit or, presumably, wholly uncollateralized. It is an odd reading of the FHLBank Act to contend that the one credit risk it specifically authorizes (advances) is subject to strict statutory requirements but that no such requirements apply to unauthorized, "incidental" activities.

The legality of this step aside, it is also poor policy and will inevitably lead to losses for the FHLBanks.

Grandfathered Transactions

Section 955.5(c) provides:

> "*Grandfathered transactions.* Assets acquired in transactions otherwise authorized by resolution of the Finance Board and that are within any total dollar cap established by the Finance Board at the time of such authorization, shall not be subject to the requirements of this section."

This provision is described in the preamble as "minor technical revisions" to the existing grandfather rule, relating to "AMA-type assets acquired by a Bank in accordance with *prior* resolutions of the Finance Board." 68 Fed. Reg. at 39,030 (emphasis added).

Grandfather provisions are commonly understood to allow existing activities to continue, even when a change in applicable law would have ended or amended them. If "prior" in the preamble is meant to convey "prior to adoption of the rule," and bind the Finance Board's interpretation of the rule, then § 955.5(c) would be a grandfather provision. As drafted, however, section 955.5(c) does not contain any "prior" reference and thus is not a grandfather provision in any sense of the term, but rather is a grant of authority to the Finance Board allowing it to exempt any Bank from any provision of the rule without notice and comment. (Under this reading, the reference to "prior" in the preamble presumably would mean "prior to acquisition of the asset.") We urge the Finance Board to clarify the matter in the event this section of the proposed rule is republished.

AMA-Qualified Interests in Whole Loans

As noted above, we oppose expanding permissible AMA assets to include interests in whole loans in addition to whole loans.

The proposed rule codifies the recent practice of allowing a FHLBank to deal with members of other banks, using that member's own Bank as a conduit. The FHLBank Act nowhere authorizes a Bank to deal with banks or thrifts that are not its own members and shareholders. This practice is a clear evasion of the Act, which we oppose.

<u>§955.8 -- Administrative and Investment Transactions Between Banks</u>

The Finance Board's current AMA rule allows one Bank (hereafter, "passive Bank") to effectively outsource its administration of an AMA program to another bank (hereafter, "dominant Bank"). The pricing function can be included in this delegation, subject only to the caveat that the passive Bank must retain a right to refuse to acquire AMA at prices it does not consider appropriate. The Finance Board seeks comment on whether to eliminate this one caveat.

Allowing a FHLBank to effectively outsource the pricing of its assets to another institution presents a serious safety and soundness risk under the current rule. Removing the one line of defense for the passive Bank effectively places it at the mercy of another

institution -- and a competitor at that. This step would raise innumerable potential safety and soundness and moral hazard issues, none of which are discussed in the proposal. For example, would the dominant Bank have an incentive to price the passive bank's AMA either artificially high or artificially low? We also question whether the officers of the passive bank would be violating fiduciary duties owed to their Bank by ceding management of a potentially significant part of the institution to a competitor. We urge the Finance Board to seek comment on these questions in the event it republishes this section of the rule.

Of course, these issues would be less serious if, according to the FHLBank Act, each FHLBank dealt only with its own members, in its own district. But the proposal envisions a FHLBank (perhaps the dominant Bank, above) soliciting loans from members of other Banks (perhaps the passive Bank, above).

§955.9 -- Risk-based capital requirements for AMA

Given that the proposal envisions the FHLBanks taking on considerably more risk than at any point in their history, capital concerns obviously arise. The proposed rule, however, effectively repeals all special capital requirements for AMA. Each FHLBank would be free to implement its own capital structure plan, governed by Part 932 of the Finance Board's rules.

The proposed rule contains no explanation of the effective capital charges that would apply to AMA assets under Part 932. We strongly urge the Finance Board to provide notice and opportunity for comment on how much capital would be held against AMA assets under Part 932 in any new proposed AMA rule.

Conclusion

We applaud the Finance Board for its announced decision to withdraw the proposed AMA rule. As our letter makes clear, we believe that the best course would be to refrain from re-issuing the proposal.

Sincerely,

Sheila C. Bair
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University of Massachusetts - Amherst

Gregory A. Baer
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July 14, 2003

Hon. John W. Snow
Secretary
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

I am writing to reaffirm and underscore Freddie Mac's commitment to completing the process of voluntarily registering our common stock with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 so that we become a reporting company under that Act. We are enthusiastically and irrevocably committed to the voluntary agreement we announced last summer to submit to the full panoply of the periodic financial disclosure reporting requirements that apply to registrants. As we have previously stated, we expect to complete the restatement and re-audit of our prior year financial statements in the third quarter of this year. Following completion of this process, we will proceed expeditiously to resume our Form 10 registration process with the SEC.

While the restatement and re-audit of prior year financial statements have temporarily delayed the completion of this process, please be assured that hundreds of professionals are working day and night to get our financial statements right, with the ultimate objective of SEC periodic reporting.

We look forward to continuing to work with you and President Bush on expanding homeownership opportunities and to meeting the highest standards of financial transparency and accountability.

Sincerely,

Greg Parseghian

Gregory J. Parseghian

cc: Hon. William H. Donaldson
Chairman
Securities and Exchange Commission

Hon. Richard C. Shelby
Chairman
Senate Banking Committee

Hon. Michael G. Oxley
Chairman
House Financial Services Committee

IS THE FEDERAL HOME LOAN BANK SYSTEM FORSAKING ITS ROOTS?

Sheila C. Bair

June 2003

Sheila Bair is Dean's Professor of Financial Regulatory Policy, Isenberg School of Management, University of Massachusetts–Amherst and Associate Professor at the Center for Public Policy and Administration. She specializes in financial services issues. Ms. Bair was formerly the U.S. Department of the Treasury's Assistant Secretary for Financial Institutions (2001–2002) and Commissioner of the Commodity Futures Trading Commission (1991–1995).

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Introduction

Growing up in rural southeast Kansas, my first impressions of the Federal Home Loan Bank System were formed by those of my parents and their depression-era contemporaries. Living through the Great Depression, they remembered the System's role in helping cash-strapped savings and loans stay afloat, and thousands of families stay in their homes.

Moreover, in the pre-branching era of my youth, the thrift institutions serving rural communities in Kansas and elsewhere, were, for the most part, independently owned, community-based institutions, which relied on the System as a vital source of funding through the cyclical ebbs and flows of deposits. The Federal Home Loan Bank System was viewed as a stable, respected American institution, one of the keys to rural America's survival through the depression, and an important source of funding for mortgage lending to facilitate achievement of that quintessential American dream, home ownership.

So it is that with those early impressions, I have retained a favorable bias toward the System in its role as a regionalized funding source for smaller, community-based lenders, though I concede the importance—up to a point—of its support for larger lenders as well. Perhaps it is because of that bias, and nostalgic fondness, that I feel compelled now to raise the alarm over a trend that I find disturbing: the transition of the System into a centralized provider of funds and services for large mortgage originators. And, if current trends continue, it could become a major player in the business of purchasing and securitizing home mortgages—a line of work much riskier than the System's traditional job of making heavily collateralized loans, and less responsive to the needs of small community lenders. Such a transformation poses safety and soundness risks to the FHLB System.

These changes are not sanctioned by the FHLB System's authorizing statute and legislative history. In addition, no compelling public policy rationale has been proffered to justify this new, expanded use of the System's status as a government-sponsored enterprise (GSE).

When Congress last acted on the Bank System in the Gramm-Leach-Bliley Act of 1999, the only major new power granted was targeted at smaller members: a directive to the FHLBanks to use their GSE-favored status to support additional forms of lending by community banking institutions. Congress didn't see fit to shift the emphasis toward the needs of larger institutions nor grant the System the right to enter the complex, higher-risk secondary mortgage market. There are two other established GSEs created expressly for the latter purpose, with capital and ownership structures tailored to that mission.

Congress also decreed that a financial institution may belong only to one FHLBank. The recent attempts at the regulatory level to allow multiple memberships would introduce a potentially revolutionary change to the System—a change that is at war with its 70-year history as a cooperative, is legally unsound, and has not been the subject of either public or Congressional review.

If the FHLBanks and their regulator want to transform themselves, they should ask Congress for that authority, and present rigorous analysis of both the supposed benefits to be gained by such an expansion *and* the potential costs, including increased risks to the federal government (both the Treasury and the FDIC).

Could such a case be made? It is my hope that this paper will help facilitate vigorous public debate on that question. I am sure that proponents of multi-district membership and mortgage securitization authority will be unhappy about some of the arguments I make. I have meant to be provocative, because I think all who depend on the Bank System need to think harder about where it is headed.

If centralization and securitization can be justified based on sound public policy and rigorous cost benefit analysis, then there is no reason why their advocates shouldn't go to Congress, make the case, and secure clear statutory approval. If such a case cannot be made, however, the System's leadership should not allow such fundamental changes to take place outside of what Congress and the law have authorized.

History of the Federal Home Loan Bank System

"The benefits of FHLB membership are vitally important to community banks and their ability to serve their customers."

Independent Community Bankers of America[1]

"ACB strongly supports the cooperatively based FHLBank System with a primary mission of providing community banks with access to advances for housing and community development lending."

America's Community Bankers[2]

"There are numerous forces at work that may drive the System to consolidation into a single, massive and very powerful government-sponsored enterprise, one that is engaged in a business and serving a function very different from the business and function it has historically performed, and more like those performed by the other two housing GSEs. By eliminating local control of the FHLBanks and undermining the regional nature of the System, it seems likely that such consolidation would reduce the System's responsiveness to the needs and priorities of local businesses and communities."

2002 Annual Report
San Francisco Home Loan Bank

The Federal Home Loan Bank System was created by the Federal Home Loan Bank Act of 1932.[3] It was the result of a proposal unveiled by President Herbert Hoover in 1931 as part of a package of economic reforms to respond to the financial crises created by the Great Depression and, in particular, to provide relief to economically distressed savings and loans,[4] and the urban and rural home owners who relied upon them for mortgage loans. Hoover's memoirs make clear that he intended the System to make mortgage money more available in good times and bad, assuring a constant flow of funding when deposits dwindled due to national or regional economic conditions.[5]

Hoover's proposal was controversial, opposed by commercial banks and insurance companies, and viewed with trepidation by fiscally conscious legislators concerned about the government's potential exposure to System losses. The bill took seven months to

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[1] *ICBA's 2003 Policy Resolution on the Federal Home Loan Bank System*, available at http://www.icba.org/ /news_views/news_views_fr.html
[2] *2003 Policy Position on the Federal Home Loan Bank System*, available at http://www.acbankers.org /government/03PolicyBook.pdf
[3] 12 U.S.C 1421, et. seq.
[4] Or *building and loans* as they were then called.
[5] The Memoirs of Herbert Hoover, 1929-41 The Great Depression (MacMillan 1952) at 111-115.

enact—slow by standards of the day—but the fundamental design that was adopted has remained for over 70 years.

The System Matures

The 1932 legislation authorized the creation of eight to twelve Banks, and established the Federal Home Loan Bank Board (FHLBB) to oversee the Banks. The purpose of the FHLBanks was to lend money to building associations, savings banks, and similar institutions primarily engaged in the business of making loans to homebuyers. The System was designed to require the Banks to over-collateralize the loans they made through the assignment of mortgages held by the borrowing institution, and to further secure them by a lien on the borrowers' capital stock.[6]

As originally enacted in 1932, the FHLBank Act temporarily authorized the FHLBanks to act as home mortgage lenders of last resort.[7] Significantly, Congress repealed this authority eleven months later, on June 13, 1933.[8] Instead, the Reconstruction Finance Corporation chartered the Federal National Mortgage Association (Fannie Mae) in 1938 to buy FHA-insured mortgages. By 1939, Fannie Mae had purchased 26,726 mortgages, aggregating more than $100 million.[9]

During the first 40 years of its existence, the Federal Home Loan Bank System matured and—with some tinkering from Congress—became an established, stable source of continual funding to support the thrift industry in making mortgage loans. In 1970 the thrift industry persuaded Congress to create a government-sponsored thrift-oriented equivalent to Fannie Mae to further support the secondary market for home mortgages.[10]

The stock of the new corporation, called the Federal Home Loan Mortgage Corporation or Freddie Mac, was owned by the FHLBanks (and, therefore, indirectly by their thrift members), and its Board was composed of the same officials who made up the FHLBB.

Thus, instead of authorizing the FHLBanks to conduct secondary market operations, Congress established a distinct, specialized corporation within the System to perform those functions. (Eventually, in 1989, investment in Freddie Mac was opened up to the general investing public and an independent, shareholder controlled Board of Directors was established.)

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[6] "New Federal Organization" (The Brookings Institution 1934) at pp 40 – 42. Over-collateralization has remained a mainstay of the FHLB System throughout its history, and the chief reason why the System can boast that its district Banks have never suffered a credit loss.

[7] Section 4(d) of the FHLBank Act of 1932. A "sunset provision" in the 1932 statute would have terminated the mortgage lending authority once the FHLBanks were fully capitalized by their members.

[8] Home Owners Loan Act, ch. 63 §3 (1933). The 1933 repeal came before the sunset date set in the 1932 legislation.

[9] Jones, "Fifty Billion Dollars" (MacMillan 1951) at pp 149-152. See also, Stanton, "A State of Risk" (Harper Collins 1991) at pp 21-22.

[10] Congress had denied retail lending power to the FHLBanks in 1969, when it rejected a provision in a bill that would have permitted the FHLBanks "to purchase, service, sell, or otherwise deal in" residential mortgages. *See* H. Rep. No. 15091 (to accompany S. 2577), Dec. 1969.

Surviving the Thrift Crisis

The thrift industry's return on assets reached a peak in 1978. Then it was hit by two successive crises. The first was caused by the soaring interest rates of the late 1970s and early 1980s. The thrift model involved making long-term, fixed-rate mortgages funded by short-term deposits. This model proved highly profitable in the post-war period characterized, as it was, by relatively stable interest rates. But when interest rates climbed to unprecedented heights beginning in the late 1970s, thrifts were squeezed between the higher rates of interest they were paying on their deposits and the much lower rates they were receiving on their long-term mortgages. Virtually the entire industry started losing money and many institutions failed.

Both the federal government and, more particularly, several of the states tried to rescue the ailing industry by authorizing new powers for thrifts. With weak supervision over the industry, many hundreds of thrifts misused their new powers, gambling on high risk loans and investments, and causing the second thrift crisis—which lead to an eventual $150 billion cleanup bill for taxpayers. Other thrifts, however, continued with their traditional home-lending orientation. These institutions recovered when interest rates declined and they constitute the healthy thrift industry that remains to this day.

Notable in this maelstrom was the resiliency of the Bank System. Membership was almost halved, falling from 4,250 in 1979 to 2,337 in 1992. Similarly, the loans FHLBanks make to members (called "advances") fell by 48% between 1988 and 1992—from $153 to $80 billion. But the System proved to be remarkably flexible and it is telling that it survived, like the now-healthy part of the thrift industry, by sticking to its traditional business of making advances to members secured by mortgage loans. In spite of the turmoil in the industry of which it was an integral part, the FHLBanks didn't suffer a single credit loss.

In addition, by opening membership to banks and credit unions, Congress was able to restore a stronger business footing for the System. In fact, the FHLBanks made a net contribution to the cleanup of problem thrifts when Congress redirected over $3 billion from the retained earnings of the Banks to help defray some of the cost of dealing with so many failed institutions.

Gramm-Leach-Bliley Act

In 1999, the Gramm-Leach-Bliley Financial Services Modernization Act[11] (GLBA) made further changes in the System's structure. These changes addressed growing problems with the capital base of the FHLBanks and re-emphasized congressional support for the System's mission to serve community-banking institutions.

Existing rules allowed any member, except a federally chartered thrift, to exit the System with six months' notice, redeeming its investment in FHLBank stock when it left.

[11] Pub. L. No. 102, 113 Stat. 1338 (1999)

Federally chartered thrifts provided the only stable source of capital because of the fact that they, and only they, were enjoined from leaving. As membership in the System broadened, this unequal approach was difficult to sustain.

Congress solved the dilemma with an elegantly simple solution. It made membership voluntary for all but provided for stability of the System's capital base by allowing the FHLBanks to capitalize themselves with stock that couldn't be withdrawn for five years.

As part of the capital restructuring, GLBA also directed the new regulator—the Federal Housing Finance Board (FHFB)—to implement new capital rules addressing leverage and risk-based capital requirements, and directed each FHLBank to submit a capital plan to the FHFB for approval. These rules, which were finalized by the FHFB on January 30, 2001, provide for a new, two-part capital adequacy test: an effective equity capital to assets leverage ratio of 4% and the imposition of risk-based capital requirements. The FHFB has now approved new capital plans for all twelve Banks, which have three years to implement the plans. Four of the twelve Banks have implemented their plans to date.[12]

Finally, Congress expanded membership to include "community financial institutions" defined as banks, thrifts, or credit unions with assets of less than $500 million (indexed for inflation), even if less than 10% of their assets were in mortgages. The GLBA also made small business, small farm, and small agri-business loans eligible collateral for FHLBank advances for members having less than $500 million in assets.

The Current FHLB System

The FHLBank System's business has grown significantly from its low level in 1992. Its membership has more than tripled and advances, its main business line, have sextupled. The number of members has grown from 2,337 in 1992 to 8,011 at the end of 2002. Advances to member institutions—its historic, core activity—have dramatically increased from $80 billion in 1992 to $490 billion outstanding at year-end 2002. These advances are collateralized primarily through mortgage loans and further supported by a borrowers' capital stock.

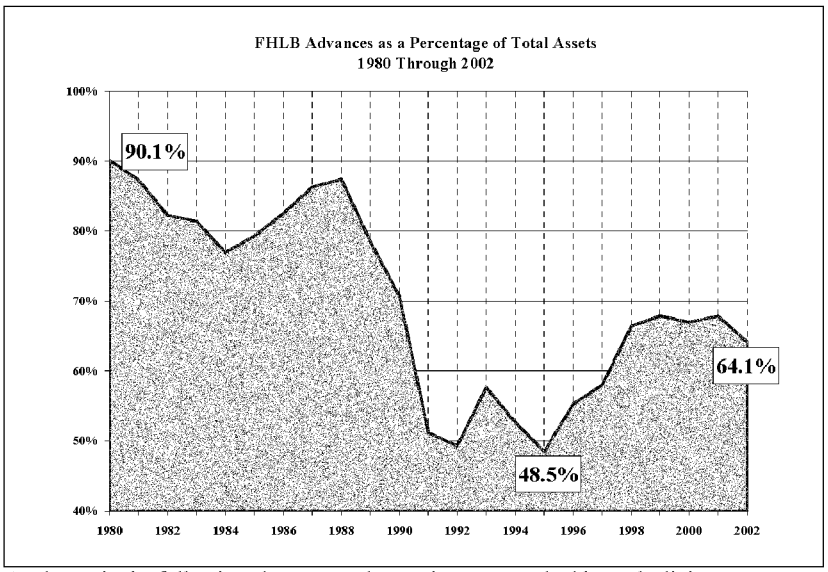
As advances fell drastically in the early 1990s, the FHLBanks changed the composition of their balance sheets by markedly increasing their portfolio of non-advance investments. As the level of advances began to recover, however, the FHLBanks continued to maintain a high percentage of non-advance investments. This enabled the Banks to leverage their capital and earn a higher level of return on it. In the late 1990's, the System's continued maintenance of significant non-advance investment activity drew fire from the Treasury Department. As the Department stated in testimony before the House Subcommittee on Capital Markets on September 24, 1998:

> "Since government sponsorship permits the FHLBanks to borrow at subsidized rates, most of their investments constitute an arbitrage of credit flows in the capital markets—borrowing funds in the capital markets at

[12] These four Banks are: Seattle, Pittsburgh, Cincinnati and Indianapolis. 2002 Annual Report, at 6.

> below-market rates and investing them in securities at market rates. … We believe that the FHLBanks' large investment portfolios violate the spirit and arguably the letter of the FHLBanks Act.[13]

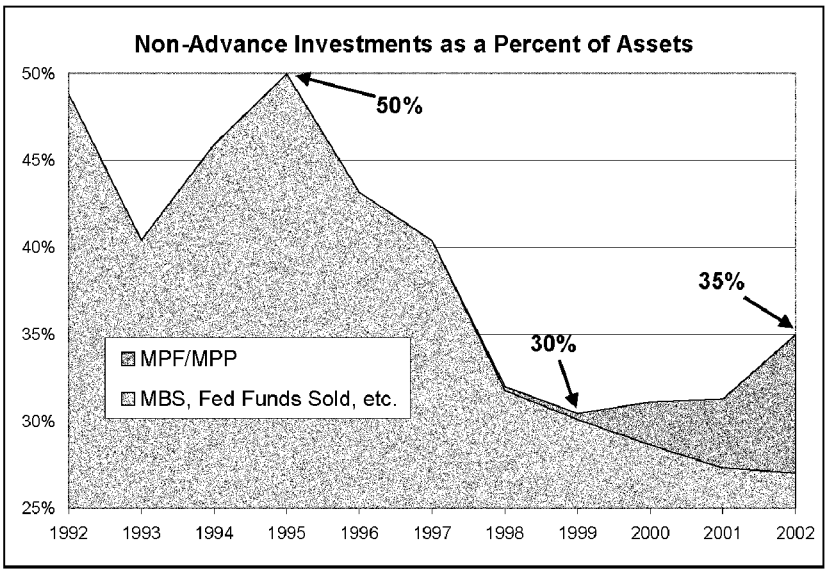
As the balance sheet of the System has changed, the percentage of the System's balance sheet made up of advances has declined significantly. In 1980, prior to the unfolding of the S&L crisis, outstanding advances represented 90% of total assets. But by 1992, that percentage had declined to 64% and has ranged from 48.5% to 68% over the past decade.



As shown in the following chart, non-advance investments had been declining as a percentage of total assets from 1995 until 1999, when the first mortgage purchase program approved by the FHFB began to grow. In fact, the FHFB expressly limited each FHLBank's MBS investments to 300% of its previous month's capital. That limitation, however, did not apply to the new mortgage purchase programs: the Mortgage Partnership Finance program (MPF) pioneered by the Home Loan Bank of Chicago begun in 1999, followed by the Mortgage Partnership Program (MPP) instituted by the Cincinnati, Indianapolis, and Seattle Banks in 2000. From 2000 to 2002, the System's cash and non-advance investments declined as a percentage of assets, from 29% to 27%. However, mortgage purchases under MPF and MPP exploded. In 2000, the first year both programs became operational, $16 billion was invested in mortgage purchases. By the

[13] Testimony of Assistant Secretary of the Treasury Rick Carnell before the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises "Federal Home Loan Banks" (Sept. 24, 1998)

end of last year, that number had climbed to $60 billion. At the end of 2002, mortgages held in portfolio accounted for 7.9% of assets, up from 4.0% in 2001.[14]



This change in the balance sheet of the System has been accompanied by proposals to make even more far-reaching changes in its structure and mission by considering multi-district membership and an even more aggressive role in the secondary mortgage market. These changes could fundamentally alter the role the System has served for over 70 years.

The Push For Multi-District Membership

The Federal Home Loan Bank Act of 1932 established the Federal Home Loan Bank Board and authorized it to establish and oversee eight to twelve regional Banks. Pursuant to that authority, the Board created twelve districts. The 1932 Act, as amended, stated that:

> An institution eligible to become a member or a nonmember borrower under this section may become a member *only of*, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's principal place of business, or of the Federal Home Loan Bank of a district adjoining such district, if demanded by convenience and then only with the approval of the Board. (Emphasis added.)

[14] FHLB 2002 Annual Report, at 22

Currently, each member of the System is a member solely of the district Bank where the member maintains its principal place of business. No single institution has been a member of more than one district Bank, though some holding companies own separately chartered subsidiaries that are members of different Banks.[15]

Consolidation has led some System members to seek out multi-district memberships to allow them membership in districts where they are not headquartered or to avoid what they view to be unnecessary and excessive costs attendant with maintaining separate charters within a holding company.

In response to these petitions, the FHFB started a formal process of soliciting comments, with the comment period expiring in the spring of 2002. The FHFB received several comments questioning its legal authority to permit multi-district memberships, (including a letter by the author when I served as Assistant Secretary for Financial Institutions).[16] The FHFB then took the somewhat unconventional step of contracting with an outside law firm, Morrison and Foerster, (instead of relying on its in-house legal staff) to provide it with a legal opinion as to whether it had the power to extend multi-district membership privileges.

An agency's own legal staff is generally viewed as the leading source of expert advice regarding that agency's authorizing statute. When an agency is uncertain about the scope or meaning of its authorizing legislation, the more typical course is to seek an opinion from the Justice Department's Office of Legal Counsel, or to seek clarifying legislation from Congress.

The outside legal opinion reached the astonishing conclusion that not only did the statute authorize the FHFB to permit multi-district membership, but *required* it to do so if necessary to carry out the FHFB's mandate that the FHLBanks operate in a safe and sound manner.[17] The FHFB then adopted a resolution requesting information from the twelve Federal Home Loan Banks "regarding the changing financial services industry, and its effect on terms of membership in the Banks."[18] Upon issuing the resolution, Chairman Korsmo indicated his hope to present "a final regulation to modernize membership terms" no later than the FHFB meeting in June 2003.[19]

The question of multi-district membership has been highly controversial among the FHLBanks' Presidents. Less than half have expressed support for it: Chicago, Dallas, New York, Pittsburgh and Seattle. Four have vigorously weighed in against the petitions:

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[15] See the FHFB's Solicitation for Comments on Multi-District Membership, at p. 2. The FHFB reports that 104 depository institution holding companies have subsidiaries that are members of different district Banks.
[16] "[T]he statutory language of Section 4(b) as well as the legislative history of the provision raise considerable doubt as to whether the Finance Board has the authority to approve multi-district membership." Letter Sheila Bair, Assistant Secretary for Financial Institutions, Treasury Department, to Elaine Baker, Secretary to the Board, Federal Housing Finance Board, April 9, 2002.
[17] Letter from Morrison and Foerster to John Korsmo (December 9, 2002).
[18] Resolution 2002-63 (Dec. 20, 2002)
[19] FHFB Press Release (December 20, 2002)

Atlanta, Des Moines, San Francisco and Topeka. The remaining three—Boston, Cincinnati and Indianapolis—are undecided but all have expressed reservations about moving forward without additional analysis and greater consensus.[20]

The Lack of Legal Authority for Multi-District Membership

The threshold question regarding multi-district membership is whether the FHFB has the legal authority to permit it, given the strictures of the above-quoted language. In its opinion to the board, Morrison and Foerster concluded that this language was ambiguous on the question:

> [T]he better view is that the Act authorizes the Board to promulgate a regulation allowing an FHLBank to grant membership to a member of another FHLBank, to the extent that the regulation furthers the mandate imposed by Congress on the Board, including that the Board "ensure that" FHLBanks "operate in a financially safe and sound manner," "carry out their housing finance mission," and "remain adequately capitalized and able to raise funds in the capital markets."

The opinion gave short shrift to the fact that the language of Section 1424(b) had been viewed throughout the 70-year history of the System as limiting membership to one district, and did not even cite FHFB Regulation 925.4(b)(1) which provides:

> Upon consolidation of two member institutions which are members of different Banks into one institution operating under the charter of one of the consolidating institutions, *the disappearing institution's membership terminates upon cancellation of its charter.* (emphasis added).

The opinion also did not discuss express legislative history cited in the FHFB's own petition for comments, which appears inconsistent with its interpretation of Section 1424(b). The petition quotes the principal drafter of the Bank Act as stating:

> [I]t was not the desire, say, for members in South Carolina to borrow of a New York bank, because it would mean *too great a concentration at the New York bank. If the New York bank happened to do better than a South Carolina bank, all members would go there.* There is the opportunity in the bill for a member whose principal place of business is in one district to belong to a bank in the adjoining district, but outside of that, there is no provision. It is impossible under the terms of the bill for a company doing business in New York to belong to a South Carolina bank.[21]

This emphasis on the regional nature of the System, combined with the fear of membership concentrations at the larger FHLBanks, supports reading Section 1424(b) in

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[20] The complete text of comment letters can be found at ttp://www.fhfb.gov/pressroom/responses2003.htm.
[21] *Notice and solicitation of comments, Multiple Federal Home Loan Bank Memberships*, Federal Housing Finance Board, available at http://www.fhfb.gov/PressRoom/petitions/Solicitation092601.htm.

a manner consistent with its plain meaning, i.e., that a System member may belong to only one district: that in which its principal business is located, *or* the adjoining district. This interpretation is also consistent with extensive legislative history that the FHLB System was patterned after the Federal Reserve System, which, pursuant to its own authorizing statute, allows an institution to be a member of *only one* district Reserve Bank.

The fact that Section 1424(b) gives members the option of joining their home district, or the adjoining district, is simply reflective of the realities of transportation and communication in 1932. A World Savings letter arguing against multi-district membership pointed out that: "It would have been considerably more convenient, for example, for an institution in western Maryland to join the FHLB of Pittsburgh, which is only 100 miles or so away, than to join the FHLB of Atlanta, which is at least 650 miles away and, especially in 1932, would have been far more difficult to reach by rail or road."[22]

The Federal Reserve Act gives a similar option to Federal Reserve System members of joining their home district Bank, or another district for "convenience" but members must still belong to only one Reserve Bank

The legal opinion concedes that this tortured interpretation of Section 1424(b) is "not free from doubt," but goes on to suggest the strictures of this section can be ignored if necessary to achieve other mandates imposed by Congress, including the broad goals of ensuring that FHLBanks "operate in a financially safe and sound manner," "carry out their housing finance mission," and "remain adequately capitalized and able to raise funds in the capital markets."

By this reasoning, when Congress granted the Board safety and soundness and mission authority, it authorized the Board to rewrite the statute however it pleases. Such an interpretation could, in essence, allow any financial regulator to ignore congressionally imposed charter limitations if necessary, in that regulator's judgment, to assure safety and soundness, mission achievement, or adequate capitalization.

Would Multi-District Membership Promote Safety and Soundness?

A leading argument in favor of multi-district membership is that it would help prevent excessive concentrations of advances at individual district Banks with a single member. Proponents of this view point to heavy single borrower concentrations at several district Banks, and argue that this "problem" would be exacerbated if, given the current pace of consolidations, merged institutions were required to consolidate advance activity at the FHLBank of the surviving merged entity. They also argue that the FHLBank losing a member as a result of a merger could suffer a dangerous depletion of capital.

It is difficult to understand why current consolidations present a problem that needs addressing. The system proved to be remarkably adaptable throughout the seismic

[22] World Savings Request to Intervene in Dallas Petition (February 21, 2001)

consolidation activity that occurred in the late 1980's, while adhering to the principle of single district membership. At that time, as well as during more recent consolidation trends, the Banks have shown that they were fully capable of expanding and contracting in accordance with the needs of their members. That flexibility lies at the heart of the System's core mission. As the San Francisco Federal Home Loan Bank stated in a comment letter opposing multi-district membership,

> [T]he FHLBanks were designed from their inception to expand and contract according to the needs of their members. This simple truth applies whether the member in question is operating in a single small town on a seasonal grow-and-shrink cycle or operating nationwide with ever-expanding needs based on successive mergers and acquisitions. …
>
> [N]o bank has ever been assured that its membership or assets will be maintained at a given level, and there is no reason for the Finance Board to seek to provide this assurance now by changing the membership rules."[23]

The San Francisco Bank was not describing a hypothetical situation in positing the ability of an FHLBank to shrink or expand. In 2002, the Bank's own advances declined from $102 to $81 billion and its assets from $135 to $116 billion primarily as a result of its members strong retail deposit growth and mortgage prepayments.[24]

Moreover, it is unclear that borrower concentration at individual district Banks is the "problem" proponents of multi-district membership make it out to be.

First, it is questionable whether borrower concentrations do present a safety and soundness issue. Given current requirements for collateralization and capital held against advances, there is little chance that an FHLBank would suffer a credit loss even if its largest borrower were to become insolvent. FHLBanks typically require security 10 – 25% higher than the value of an advance when the collateral is a mortgage. They can require 60 – 150% more when the collateral consists of small business or farm loans.[25] With such generous amounts of collateral against advances, as well as the borrower's capital stock, credit risk is virtually eliminated.

Second, if there is a problem of concentration, it is a problem that applies to the *System's* exposure to a small number of large borrowers, not the exposure of individual Banks. Because the consolidated obligations that support each district Bank's lending activity are the joint and several liability of all district Banks, it is ultimately the System, not the

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[23] Letter to Elaine Baker, Secretary to the FHFB Board from Dean Schultz, President and CEO, Federal Home Loan Bank of San Francisco. (Feb. 6, 2003)

[24] Interestingly, the significant decline in advances at the San Francisco Bank was caused by its largest members but had no relationship to the supposed problems created by restrictions on multi-district membership. "The decline in advances outstanding was primarily the result of several members' strong retail deposit growth and mortgage prepayments. The Bank's largest members accounted for most of the decline in advances." 2002 Annual Report, Federal Home Loan Bank of San Francisco at 25.

[25] GAO Report "FHLB System: Establishment of a New Capital Structure" at p. 14.

individual district Bank, that would have to make up for shortfalls resulting from a large borrower's default.

There is no reason to think multi-district membership would do anything to mitigate the System's exposure to concentrated borrowings by a few large institutions. It is just as likely that the ability to become a member of multiple district Banks would increase a large borrower's activity in the System as a whole. In addition, allowing one member to have multiple relationships with FHLBanks would increase operational risk since they lack safeguards to obviate the multiple pledging of collateral or clash of competing blanket liens. As the Topeka FHLBank stated in its comment letter:

> We strongly believe that having a single point of credit management relating to a single financial institution charter creates significantly less risk than would a situation where multiple FHLBanks are trying to manage competing credit relationships with the same institution.[26]

Multi-District Membership Could Destabilize the System

Far from enhancing safety and soundness, it appears more likely that multi-district membership could have a destabilizing effect on the System, putting large institutions with multi-district memberships in the position of being able to "shop" their advance activity to multiple Banks. A World Savings letter to the FHFB stated:

> [T]here will be a very high temptation for all the Banks to compete on some basis for business of large multiple members, and that competition is likely to be cut throat. Members quickly would shop for Banks with lower capital requirements, or lower advance rates, or more favorable MPF criteria or more lenient collateral requirements. … A kind of race to the bottom would inevitably result, as we have seen in all-too-numerous other credit situations.[27]

Concern about the potential destabilizing impact of multi-district membership on credit standards was a recurring theme in letters filed by FHLBanks opposed to multi-district membership, and was also cited by undecided Banks. As the San Francisco Bank put it:

> Competition would not occur in pricing past a certain point, because the FHLBanks can employ the same funding strategies and raise funds at substantially the same cost. Competition would then have to occur in credit and collateral standards and procedures. An FHLBank that lowers its standards would win more multi-district members, but would increase risk for the System—that is for the FHLBanks that didn't lower their

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[26] Letter to the Honorable John Korsmo, Chairman, FHFB, from Andrew Jetter, President and CEO, FHLBank of Topeka. (February 7, 2003)

[27] Letter to the Multi-District FHLBank Membership Roundtable from Herb Sandler, Chairman and CEO, World Savings (Jan 8, 2002)

> standards, but yet remained jointly and severally liable for risk taker's debts.

Even though a supporter of multi-district membership, the president of the Seattle FHLBank has acknowledged this as an issue:

> [M]ultidistrict membership will increase competition amongst the district banks. Given that the Federal Home Loan Banks all raise funds the same way, no bank can have a lasting price advantage. Unable to compete on price, there's the possibility that we'll compete on collateral and credit standards. And unless regulatory changes are made, that could be very risky for everyone.[28]

Among undecided banks, the FHLBank of Boston was typical in stating it was "particularly concerned about the potential for destabilizing competition among the Banks on both price and non-price issues such as credit underwriting and collateral which may adversely effect the System's risk profile and raise safety and soundness concerns."[29]

Diminution of credit quality by large FHLBank System borrowers would have adverse ramifications not only for the System, but the FDIC as well. This is because FHLBanks have a "super lien" that is superior to all other creditor claims in the event of a member institution's insolvency—a lien that takes precedence even over the claims of FDIC-insured depositors (and of the FDIC as receiver).

This super lien can be expensive to the FDIC when it is forced to take over an insolvent institution with significant outstanding FHLBank advances. The FDIC will typically take over an insolvent institution on a Friday afternoon, giving it the weekend to line up a purchaser before the bank is scheduled to re-open on Monday. The problem: advances are secured by liquid, high quality assets—the kind that would be attractive to potential purchasers.

To preserve these assets (and with little time to negotiate with the FHLBank), the FDIC is forced to pay off the advances in full. Because the advances are paid off prior to maturity, the FDIC generally must also pay a prepayment penalty to the FHLBank. These prepayment penalties are calculated based on what it will cost the FHLBank to unwind its interest rate hedge on, or otherwise replace, the advance, and can thus be significant on a long-term advance which carries an above-market rate.

The failure of the Bank of Alamo last year presents a severe example of how costly these prepayment penalties can be. The FDIC was forced to pay off $6.4 million in advances, plus another $906,000—a whopping 14%—in prepayment penalties.[30]

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[28] Address to Stockholders, Norman B. Rice, President, FHLBank Seattle, May 14, 2003.

[29] Letter to Elaine Baker, Secretary to the Board, FHFB, from William P. Morrisey, Chairman; David Holland, Chair, Multi-District Membership Task Force; and Michael Jesse, President and CEO, FHLBank of Boston.

[30] Briefing Paper "Federal Home Loan Bank System" (Office of the Chairman, FDIC, distributed at the April 22, 2003 Meeting of the FDIC Banking Policy Advisory Committee.)

Because of the adverse effects heavy FHLBank borrowing by a failed bank can have on FDIC reserves, the agency takes a keen interest in large concentrations of advance activity in individual FDIC-insured institutions. Last fall, it conducted an extensive safety and soundness analysis of 80 of the FHLBank System's largest borrowers that are supervised by the FDIC.[31] These included 46 state banks and 34 mutual savings banks, with average assets of approximately $520 million.

The average advance-to-total-asset ratio at these institutions ranged from 14 to 51%, with the average being 29%. The good news: 78 of the 80 institutions have composite CAMELS ratings of 1 or 2. Only two had a less acceptable composite rating of 3. Based on the high supervisory ratings of the vast majority of FHLBank borrowers, the FDIC staff found that their concentrated borrowings did not present a major supervisory concern.

The FHFB and district Banks should take some pride in this finding by the FDIC staff. It also underscores an important point made by opponents of multi-district membership: that currently there is no problem regarding the concentration of advances, and "if it ain't broke, don't fix it." The current structure seems to be providing the right balance for prudent lending practices. The introduction of competition among district Banks through multi-district membership, however, could very well destabilize current practices and result in a deterioration of credit standards for large borrowers.

Multi-district Membership Would Benefit Only Large Lenders

Finally, of course, from the point of view of the membership of the Bank System, the push to multi-district membership is, almost by definition, an attempt to accommodate large members. By their very nature, community banks will not be seeking membership in multiple Banks. Proponents have argued that multi-district membership will benefit smaller institutions who will enjoy the "trickle down" effect of more favorable pricing resulting from FHLBanks competing with each other for the business of large, multi-district members. However, as discussed above, far from promoting more efficient pricing, competition among the Banks would more likely result in a diminution of credit and collateral requirements.

"Modernization" has also been a leading catchword to promote multi-district membership. But what does "modernization" mean in the context of GSEs? Most GSEs were created in the aftermath of the great Depression, to address a market failure in the provision of credit in key economic sectors. If "modernization" is the rationale for supporting fundamental changes in GSE structure without statutory support, where do we draw the line?

In short, there are good reasons why the Federal Home Loan Bank Act does not allow multi-district membership. It is simply not compatible with the law or the basic concept

[31] Because the analysis was confined to FDIC supervised institutions, this analysis did not include many large thrift and commercial bank users of the System.

of the System—a cooperative consisting of regional Banks tied together by the joint raising of funds and the joint liability for the resulting obligations. With multi-district membership, the Banks could not compete for members' business with each other based on the cost of funds. Instead, the temptation would be to compete based on relaxed credit and collateral standards. Therein lies folly.

The Mortgage Purchase Programs

In 1997, the FHFB granted authority to the FHLBank of Chicago to initiate a pilot program called "Mortgage Partnership Finance" (MPF), which allowed the Bank to directly acquire mortgages originated by its members. The Chicago FHLBank designed the program as a strategic alternative for its members to holding loans in portfolio or selling them in the secondary market. Under the program, the Chicago FHLBank buys mortgages and holds them in portfolio, fully assuming the interest rate, liquidity and prepayment risk associated with the loans. The member retains marketing, servicing, and part of the credit risk—the latter through credit enhancements established by the Chicago FHLBank.

Originally capped at $750 million, the pilot was a major success and the now-permanent program has grown exponentially—reaching $42.3 billion last year, with all but three of the Federal Home Loan Banks participating. The remaining three, Seattle, Cincinnati, and Indianapolis started their own, substantially similar program, the Mortgage Purchase Program (MPP) in 2000.[32] That program, at the end of last year, had grown to $18 billion.

MPF was controversial when it was first approved. An unsuccessful legal challenge was brought to the FHFB's authority to approve the program based on the fact that there is nothing in the Bank System's legislative history or authorizing statute granting authority for direct mortgage purchases, and two other GSEs, i.e., Fannie Mae and Freddie Mac, were established and chartered expressly for that purpose. The court, however, upheld the FHFB's action, based on the strong deference generally given to agencies in interpreting their own authorizing statute.[33]

Though controversial, analysts assumed until recently that MPP and MPF could not become a significant factor in the trillion-dollar secondary mortgage market because of charter limitations and the Banks' capital structure.[34] When an FHLBank buys a mortgage, it becomes an asset on the Bank's balance sheet. Thus, under the 4% capital-to-asset ratio adopted by the FHFB, the Bank must attract sufficient capital to assure that it maintains this 4% ratio as the volume of mortgages held by the Bank grows.

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[32] The FHLBank Atlanta participates in both programs.

[33] Texas Savings & Community Bankers Association, et al vs. Federal Housing Finance Board, 201 F. 3rd 551 (5th Cir. 2000) The Court upheld the FHFB's approval of MPF under Chevron v Natural Resources Council, 467 U.S. 837 (1984) which requires the federal courts to give heavy deference to agency interpretations of statutes they administer.

[34] See, e.g., "FHLBs Lack Structure to Dent Fannie and Freddie, Report Says" (American Banker Sept. 16, 2002) and Specialty Finance: Mortgage Stuff Ideas, Gary Gordon, UBS Warburg, September 12, 2002.

Publicly traded companies, such as Fannie Mae and Freddie Mac, can access the capital markets through public stock offerings to maintain sufficient capital to support expanded acquisitions. An FHLBank, however, can only raise additional capital through stock purchases by its members. In addition, Fannie and Freddie make greater use of retained earnings to build capital, whereas the FHLB System tends to pay out more of its earnings in dividends.[35]

Fannie and Freddie can also serve originators by securitizing mortgages that can be sold to the public as mortgage backed securities, or MBS. The FHLBanks' charter does not authorize them to securitize mortgages to get these assets off their balance sheets.

If these programs are truly meant to acquire mortgages from smaller institutions, FHLBanks could issue new capital stock to members selling loans to them, build retained earnings or replace non-advance investments with MPF/MPP loans. Securitization would only seem to be necessary to accommodate wholesale acquisition of mortgages from large lenders.

Charter limitations notwithstanding, securitization has been embraced by MPF/MPP advocates.[36] Such a step, however, is flawed on both legal and economic grounds. While Congress has reviewed the System on several occasions, it has repeatedly declined to provide any authority to securitize mortgages.

In addition, a committee of FHLBank chief financial officers was reportedly unenthusiastic about the economic viability of a securitization program.[37] Pointedly, however, FHLBank Chicago was not represented on the CFO committee. Indeed, securitization seems to be the direction in which the Chicago FHLBank is heading with its new "Shared Funding Program."

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[35] In 2002, the FHLBanks paid 51% of their income in cash dividends. (They paid another 46% in stock dividends, for a total of 97%, but such dividends represent a transfer from retained earnings to the capital stock account rather than a diminution in capital). Fannie Mae paid 23% of its net income in dividends, Freddie Mac 15%. Since 1980, the System's capital to asset ratio has declined from 11% to 4.76%, which appears to be due, at least in part, to its operating philosophy of paying out a large portion of earnings as dividends as well as the redirection of retained earnings to pay for the thrift clean up.

[36] "Going forward, securitization of MPF assets will become an increasingly important priority for us." James D. Roy, President FHLBank Pittsburgh at http://www.fhlb-pgh.com/news_pub_7-17.html.

[37] "The Federal Home Loan banks' booming mortgage-purchase programs will eventually drive them to seek more capital, but the most obvious source—loan securitizations—currently does not appear to be a viable option, according to a draft internal report... The problem, according to the draft, is the fact that the lenders retain the credit risk on the loans they sell, while the Home Loan banks take on the interest rate risk. If the loans were then securitized, the banks would be laying off to investors the interest rate risk, which generates the majority of the return." *Will FHLB Loan-Buying Plans Hit Capital Wall?* Rob Garver, *American Banker*, September 27, 2002

The Shared Funding Program

The Shared Funding Program was quietly approved by the FHFB staff last December, with virtually no meaningful public discussion or input.[38] As discussed below, this program allows the Chicago Bank to circumvent charter limitations on its own issuance of MBS by partnering with one of its member institutions. Shared Funding provides a potential vehicle for MPF and MPP to grow significantly, raising concerns anew about the inconsistency of these programs with the FHLBank System's charter, structure and capabilities.

Under the Shared Funding Program, MPF-eligible loans are sold to a *member* of the Chicago Bank, which then issues its own "private label" securities backed by these loans. Two tranches of securities are created, with the senior tier being sold to the Chicago Bank or other FHLBanks participating in MPF, which may in turn sell some or all of the securities to System members. The member securitizing the loans may sell the subordinated tier of securities anywhere in the capital markets or hold them in portfolio. As described in a recent issue of *Inside Mortgage Finance*, a widely read trade journal in the mortgage finance industry, "The Chicago FHLBank … got around the obstacles facing direct Bank issuance of MBS by creating a program where the Banks support what amounts to a non-agency, private label MBS program as investors."[39]

The Chicago FHLBank completed its first Shared Funding transaction on March 21, 2003. The $475 million offering was backed solely by MPF loans originated by Wells Fargo Home Mortgage and National City Mortgage, two of the biggest mortgage originators in the country. FHLBank member Bank One created the conduit to issue the securities. Because these were private placements not subject to SEC registration requirements, important details were not disclosed about the collateral and structure of the offering.[40]

According to *Inside Mortgage Finance*, the senior classes of the transaction were purchased by the FHLBanks of Chicago, Des Moines, and Pittsburgh, with Bank One acquiring the subordinated classes. Perhaps the biggest question about the offering was how the price Wells Fargo and National City Mortgage received compared to prices offered by Fannie Mae and Freddie Mac. Industry speculation is that the FHLBanks paid generously for the Shared Funding MBS "since the securities are treated as 'member assets' for regulatory purposes and are not subject to the cap applied [FHL]Bank investments in agency MBS as a percent of capital."[41]

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[38] Letter to Alex Pollock, President, FHLBank of Chicago from Arnold Intrater, FHFB General Counsel (December 4, 2002)

[39] *Inside Mortgage Finance,* March 28, 2003, at p. 5.

[40] Not even to other Federal Home Loan Banks who are partners with the Chicago Bank in MPF and who are liable for consolidated obligations issued by the System on behalf of the Bank. As Raymond Christman, President of the Atlanta FHLBank, stated in a letter to Congressman Harold Ford on April 29: "[I]t is unfortunate that full disclosure and public understanding of the recently developed MPF Shared Funding Program did not occur."

[41] *Inside Mortgage Finance,* Id.

SFP is a private-label MBS rather than a securitization of the Chicago FHLBank. However, at least one FHLBank President has characterized it as a stepping stone to such a program being adopted by the Bank System or individual Banks.[42,43] What is all the more extraordinary about this step being taken is the fact that a committee of FHLBank Chief Financial Officers found that securitization was not a good business decision for the System.[44]

The study concluded, according to reports, that "under the current system a securitization program would lose money, even in the best-case scenario."[45]

So if securitization generates losses for FHLBanks, and is unnecessary to serve small community lenders, whose interest does it serve? The conclusion is inescapable. The beneficiaries will be the large members of the Bank System.

These large members are already the drivers in the MPF and MPP programs. Supporters of MPF and MPP routinely claim that the programs benefit small, community-based lenders with a more favorable pricing structure, because they are compensated for retaining the credit risk of the mortgages they originate. But available data suggest that it is the nation's largest mortgage originators who are primarily benefiting from the programs. A trade journal recently identified Wells Fargo Home Mortgage (at $11.7 billion) and National City Mortgage (at $11.3 billion) as the top two in mortgage sales to the FHLBanks in 2002. The same article reported that the top five institutions sold $42.7 billion in mortgages to the FHLBs.[46] If this report is accurate, these five institutions would account for almost all of the $45.7 billion dollars in FHLBank mortgage acquisitions in 2002.[47]

Safety and Soundness Considerations with Mortgage Acquisitions

A fundamental selling point in the marketing of the MPF/MPP programs is the unbundling of risks associated with a mortgage, and assignment of those risks to the institution best suited to manage them. As described by the Chicago FHLBank, "[T]he Federal Home Loan Banks are responsible in an MPF transaction for managing the interest rate risk, prepayment risk and liquidity risk of the fixed-rate mortgages because of their expertise at hedging such interest rate risks and their ability as a GSE to raise low-cost, long-term funds in the global capital markets."[48] The description also indicates

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[42] Norman B. Rice, *Id.* at fn. 27 "You may have already heard that the Chicago Bank recently was approved for a limited securitization program that involves only Federal Home Loan Bank members. This is a first step."

[43] Not all FHLBanks agree that it is a necessary step. In describing its MPF purchases, FHLBank New York said in its 2002 Annual Report: "We have no need to securitize these assets."

[44] See, *Will FHLB Loan-Buying Plans Hit Capital Wall?*, Rob Garver, American Banker, Page 1, September 27, 2002

[45] *Id.*

[46] *Inside the GSEs* (April 2, 2003) at 6.

[47] 2002 FHLBank System Annual Report at 22.

[48] Providing interest-rate and prepayment risk protection rings hollow as a justification for MPF/MPP. In their established advance business, the FHLBanks insist that they themselves be protected against interest

that because "lenders know their customer better" they are given the primary responsibility of managing the credit risk, as well as other functions involving the customer relationship such as marketing and servicing. [49]

The FHLBanks may well have greater expertise and capability in managing certain kinds of interest rate risk than a small, community-based lender. However, it defies credibility to think that they have expertise superior to institutions like Wells Fargo Home Mortgage or National City Mortgage in managing the interest/prepayment risks associated with mortgages. Yet these large mortgage originators are precisely the type of institutions dominating the System's mortgage acquisition programs.

Operational risk may be the most significant new risk the Banks face in acquiring mortgages. There is a serious question as to whether the FHLBanks have sufficient numbers of qualified staff to build the needed infrastructure and manage even the day-to-day foreseeable risks associated with major secondary mortgage market participation. To be sure, the FHLBank System employs a number of highly talented, dedicated professionals—and total staff across the System comes to 2,183 employees. However, they are spread out among twelve Banks and the Office of Finance and have traditionally been focused on supporting the System's core mission of providing advances, which involves risks significantly different from those associated with mortgage acquisition or securitization.

Moreover, the staff of each FHLBank is relatively small. The Office of Finance, which issues the consolidated obligations that support FHLBank activity, employs only 57 people. The full-time staffs of the individual Banks range from 122 (Seattle and Dallas) to 278 (Atlanta). The Chicago FHLBank employs 218 full-time staff. This compares to the 3,900 employees of Freddie Mac, and nearly 5,000 at Fannie Mae, managing combined mortgage portfolios of $1.3 trillion. These huge disparities underscore concerns that the FHLBanks are ill-equipped to undertake a major foray into the secondary mortgage market.

With regard to credit risk, though MPF/MPP are designed to assign this risk to the originating institution, the FHLBank still maintains some exposure. As acknowledged in the FHLB System's third quarter financial statement, "[mortgage] assets may have more credit risk than advances, even though the member or housing associate provides credit enhancement."[50]

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rate risk at the expense of the borrowing member: "[E]ach FHLBank generally charges a prepayment fee that makes it financially indifferent to a borrower's decision to prepay an advance." Federal Home Loan Banks' 2002 Financial Report at 36. In fact, with the popular so-called convertible advances, which can be put back by the FHLBank to the member, both the FDIC and the FHFB have complained that the FHLBanks are essentially ***increasing*** members' interest rate risk. See, *Refinancing Waves Alter the Landscape for Mortgage Specialists*, FDIC, April 25, 2002 and *Profile of the Federal Home Loan Bank System December 31, 2001*, Office of Policy, Research and Analysis, Federal Housing Finance Board.

[49] "How the MPF Program Works" www.fhlbmpf.com/MPF.

[50] FHFB 2002 Third Quarter Report, at 22.

As with mortgages sold to Fannie Mae or Freddie Mac, MPF loans with down payments of less than 20% are required to have private mortgage insurance. In general, losses beyond this are absorbed by a "first loss account" established by the FHLB. "Second losses" beyond this layer are absorbed by the member through reductions in the monthly "credit enhancement fees" paid by the FHLBank. However, the adequacy of enhancements established by Chicago and the other FHLBanks are essentially dependent on their expertise in interpreting historical default data to estimate credit losses, which again is outside their traditional mission and experience in making advances. The FHLBank is responsible for losses beyond the member's exposure.

Questions about the capability of the FHLBanks to manage new risks associated with their mortgage purchase programs are heightened by longstanding weaknesses in the FHFB examination processes, identified by the Government Account Office (GAO) in 1998 and again in 2002. Though Chairman Korsmo has taken a number of steps to address these weaknesses, including increasing the number of examiners and putting greater focus on major risks and the quality of controls at FHLBanks, the GAO found in a report released in February of this year that it is still too soon to evaluate the effectiveness of these measures.[51]

The FHLBank's SEC Exemption

On July 16, 2002, with strong White House backing, Treasury Under Secretary for Domestic Finance Peter Fisher called upon all three of the major housing GSE's to register their stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Though Fannie Mae, Freddie Mac, and the FHLB System enjoy statutory exemptions from SEC registration requirements—another benefit of their GSE status—Fisher pointed out that as "large rapidly growing and important players in our capital markets and in our banking system…they need to be role models for our system of investor protection, not exceptions to it."[52]

Four days prior to Fisher's statement, Fannie Mae and Freddie Mac had announced their decision to voluntarily register their stock as provided under Section 12(g) of the '34 Act with strong public support from Fisher and then-Treasury Secretary Paul O'Neill. A few days after Fisher's statement, FHFB Chairman John Korsmo announced his support for "full disclosure requirements for the Federal Home Loan Bank System" and indicated that he had initiated talks with the Securities and Exchange Commission and the Department of Treasury about expanding financial disclosure reporting in response to Fisher's call. Korsmo also added, "I firmly believe that the public has a right to know at least as much about the Home Loan Banks as they do about the publicly traded companies in their retirement funds." [53]

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[51] GAO Report "Review of Selected Operation of the FHFB" (February 2003)
[52] Testimony of Peter Fisher before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (July 16, 2002) at http://www.ustreas.gov/press/releases/po3259.htm.
[53] FHFB Press Release, July 16, 2002. "FHFB Chairman Embraces Call for Full Disclosure"

Korsmo's willingness to engage Treasury and the SEC on the '34 Act registration issue has been controversial among the FHLBanks and its members. In general, the Banks have argued[54] that because their stock is not publicly traded, but rather held by System members, and because they are separately regulated by the FHFB, the regime established under the '34 Act does not "fit" their situation. They maintain they are not opposed to full disclosure, in accordance with SEC requirements, but feel those disclosures should continue to be filed with, and regulated by, the FHFB.

The Banks have pointed out that federally chartered banks enjoy a similar exemption from '34 Act registration, and are required only to file their corporate disclosures with the federal bank regulators.[55] They have further expressed concern that '34 Act registration could lead the SEC to impinge on the FHFB's authority as their safety and soundness regulator.[56] On December 17, 2002, Korsmo announced that he was deferring action on both proposals to register the System's debt and capital stock with the SEC pending further discussions, though he continues to speak out for improved disclosure.

The FHLBanks and their members argue that their cooperative structure makes them different from publicly traded corporations, but this is not a valid basis for escaping SEC scrutiny of public financial statements and other required disclosures.[57] In fact, absent an SEC exemption, the Banks would be required to file periodic reports under the Securities Exchange Act of 1934 due to either the public offering of their debt securities[58] or the number of common shareholders.[59]

The Administration is trying to promote consistency and comparability in disclosures to investors, and the SEC, as lead overseer of corporate disclosures, is the obvious vehicle for accomplishing that objective. Concerns about the SEC potentially interfering with the FHFB's role as safety and soundness regulator are misplaced. The '34 Act registration regime is based on *disclosure*. SEC review of corporate filings is focused on ensuring their accuracy and fairness, not the financial integrity of the company.

Technical arguments made by the FHLBanks regarding their unique cooperative status also are misplaced. Whether the FHLBanks register their stock or their debt securities under the '34 Act is not important. What is important is bringing the FHLBanks within the SEC's periodic reporting regime. The registration of Fannie Mae's and Freddie Mac's common stock brings these companies within the '34 Act reporting system, which

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[54] See, e.g., FHFB Public Hearing on Disclosure (December 2, 2002)

[55] Though this is a valid point, it should be noted that the largest federally chartered banks, typically operate under a holding company structure, which is publicly traded and regulated by the SEC.

[56] The SEC has a long history of working cooperatively with the federal banking regulators due to its regulation of bank and thrift holding companies.

[57] Cooperative status does not in itself bestow an SEC filing exemption. There are numerous cooperative associations who are required to file periodic under the '34 Act.

[58] The Bank System is one of the world's largest issuers of debt securities. Under the SEC's integrated reporting system, issuers of debt securities in public offerings must file periodic SEC reports under Section 15(d) of the '34 Act.

[59] Section 12(g) of the '34 Act requires entities with more than $1 million in assets to register securities held by more than 500 investors, absent an SEC exemption. Six of the twelve FHLBanks (Des Moines, Atlanta, Chicago, Dallas, Topeka and Cincinnati) had more than 500 investors as of December 31, 2002.

benefits not only their stockholders but the holders of their debt securities as well. While the FHLBanks may not be concerned with the level and quality of financial disclosures provided to their member institutions (i.e., their stockholders), policymakers should be concerned with the level and quality of financial disclosures to their public debt holders.

Moreover, if, as the FHLBanks claim, they are already fully disclosing that which is required under the ’34 Act, this seems like a debate of form over substance. By resisting SEC registration, the FHLBanks create the perception that the System is resisting transparency, an untenable position in this post-Enron environment. Such lack of transparency only exacerbates concerns that as the FHLBanks take on new business ventures, the risks will not be apparent to the taxpaying public that could end up footing the bill.

Conclusion

New ventures like mortgage purchase programs and privately placed securitizations, perched precariously atop a system based on joint and several liability with limited public disclosures are trends that I find deeply alarming. What will happen if these programs continue to grow unchecked? If, in pursuing dreams to become a major competitor in the secondary mortgage market, the System assumes major new risks that it is ill-equipped to manage, will these programs topple and fall, bringing down the entire System with them?

The System was able to survive the S&L debacle primarily through the lobbying clout of community based institutions, and its populist, historic mantle as friend to small, community-based thrifts. Those institutions were also instrumental in many of the beneficial provisions enacted as part of GLBA. Yet, the changes taking place now primarily benefit the System's largest members, and are alienating many of the smaller, independent institutions, which have long been part of its core constituency.

The System is taking risks for which it is not prepared, and inviting scrutiny and controversy by forging ahead with activities that far exceed its Congressional charter and with which it has no historic experience or expertise.

The thrift experience has shown that lenders cannot safely rely on short-term deposits to fund long-term fixed-rate mortgages; access to capital market funds is necessary. Congress has settled on two GSE models whereby financial institutions, particularly community banks, active in the mortgage market can gain such access. One is through securitizing and selling loans through Fannie Mae or Freddie Mac. The other is through holding loans in portfolio financed with Federal Home Loan Bank advances.

Through its advance business, the Bank System already provides competition to the other two housing GSEs since it offers member institutions the basic opportunity to hold fixed-rate mortgages safely in portfolio instead of having to sell them into the secondary market.

Every indication shows that the vast bulk of the System's membership, as distinct from a handful of its largest members, values advances far above any other service the FHLBanks can provide. Yet, the Chicago and Pittsburgh banks have decided to apply 0% capital requirements to mortgage acquisitions, in sharp contrast to the full capital requirements applicable to users of advances.

While it is difficult to see the public policy benefits to be derived from the System's foray into the secondary mortgage market, it is very easy to see the significant risks. If left unchecked, this current expansion will likely increase the overall amount of GSE activity in the secondary mortgage market, and thus taxpayer exposure, while injecting new operational and credit risks as the System seeks to establish market share.

If the System does stumble, it is doubtful that Congress will be of a mind once again to resurrect it. More likely, it will simply be the end of an institution, which still has vital relevance in its core mission of providing advances to meet the funding needs of member institutions. Hopefully, Congress, the FHFB, or better yet, the System's leadership on its own will reverse these dangerous trends and preserve a System that still has a vital role in our mortgage finance system.