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A REVIEW OF THE FEDERAL HOME LOAN BANK SYSTEM

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

SEPTEMBER 7, 2006

Printed for the use of the Committee on Financial Services

Serial No. 109–117

U.S. GOVERNMENT PRINTING OFFICE

31–546 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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A REVIEW OF THE FEDERAL HOME LOAN BANK SYSTEM

Thursday, September 7, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Castle, Manzullo, Royce, Kelly, Biggert, Tiberi, Hensarling, Davis of Kentucky, Campbell, Kanjorski, Hooley, Moore of Kansas, Hinojosa, Clay, Baca, and Scott.

Ex officio: Representatives Oxley and Frank.

Chairman BAKER. I would like to call the hearing to order. The committee meets today to review the status of the Federal Home Loan Banks, and their regulatory regime, and the Federal Housing Finance Board, including the latest significant developments within the Federal Home Loan Bank system.

I am pleased that Chairman Ronald Rosenfeld is our single witness for today's hearing. The bank system was established in 1932 to provide liquidity to savings and loan associations which were the primary home mortgage lenders in that period. The Bank System today encompasses 12 regional Federal Home Loan Banks, patterned on the structure of the Federal Reserve System. Each is a member-owned cooperative.

Like the other housing government-sponsored enterprises, Fannie Mae and Freddie Mac, Congress granted the Bank System special privileges as part of their governmental charter. Those privileges include exemption of the Banks' corporate earnings from Federal, State, and local taxes, and the status of debt issues as government securities for the purpose of compliance with securities law.

The Bank System has enjoyed significant growth, roughly to the same size as our competitors, Fannie Mae and Freddie Mac. As of June 30, 2006, the System's assets were $1 trillion, of which $638 billion were advances to members. The System has outstanding debt obligations of $940 billion.

In recent years, Federal Home Loan Banks have established and participated in what is known as a mortgage purchase program, whereby credit and interest rate risk are shared between member institutions that originate the loan and the bank purchasing the loan.

Accordingly, in light of the growth and programmatic changes, review of their regulatory requirements is not only appropriate, but necessary. This committee has engaged in significant review and oversight of Fannie Mae and Freddie Mac throughout the years, but we have not as frequently examined the structure or requirements of the Federal Home Loan Bank System.

Today, we shall hear comment, I am certain, from members with regard to a rule now pending, as proposed by the chairman, some of whom will express concern about the proposal. I want to express my appreciation to the chairman for his principled hard work, and to his examination staff for the frequency of the examinations which they perform.

I recognize that the purpose of this work is not simply to artificially constrain the Bank System, but to ensure that there are adequate protections in place for the taxpayer, who ultimately would be found responsible for failures of a significant nature within the system.

However, I want to make clear that the pending rule revision and the actions taken are really interim steps, in that this committee has passed, and the House has passed, H.R. 1461, which provides for the creation of a unified housing regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. I continue to be troubled that there are disparate rules governing the practices of each, not only capital requirements but business conduct as well.

Some criticism has been leveled at H.R. 1461 for its failure to address the issue of portfolio constraint, and I wish to make clear on behalf of the committee one more time that the bill makes express provision that the new director created by the Act shall examine and report to the Congress on the appropriate constraints, and the methodology to impose such constraints, in order to effect the leveraging of portfolio for shareholder profit, as opposed to the compliance of charter requirements.

Stated another way, when asking Secretary Snow just last year whether the portfolio should be constrained to a dollar certain, or did he have in mind a particular formula to which reduction would be applied, he suggested to the committee that there should not be a dollar certain reduction, nor did he have in mind a formula by which portfolios should be reduced.

But rather, that should be the subject of study of professional staff, and recommendations to the Congress in order to assure that we did not royal the housing markets unnecessarily. That's exactly what H.R. 1461 does.

More importantly, whether there is a difference between House and Senate language over the regulatory details of GSE governance, I think it extraordinarily important that while we still have stability in the housing market, and while we still enjoy relatively flat interest rates, that the Senate at least act on a GSE proposal.

Without doubt, there will be a conference committee. We have come too far, worked too hard, and have two proposals—each of which has their own validity—to let this legislative opportunity pass us by. And so, I would hope and urge that the Senate would act before our final adjournment, perhaps late November, early December, with the adoption of some form of GSE proposal.

If we were able to do so, perhaps it would be of assistance to the current Federal Home Loan Bank regulators in the matter now pending. Knowing that the goals they are trying to reach, the patterns that they establish with their regulatory construct, would be of great benefit in going forward, with the creation of the new consolidated GSE regulator. So, I am appreciative of Chairman Rosenfeld's bold leadership, and I commend him and his staff for his good work, and look forward to his statement at the appropriate time.

Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, we meet this morning to once again examine the Federal Home Loan Bank System. As you already know, I share your deep interest in these important financial institutions. After all, we worked closely together for several years to include language to improve the system during our lengthy deliberations over H.R. 10, the landmark law to modernize the financial services industry.

Perhaps most importantly, our joint efforts in 1999 resulted in a much needed update of the capital structure in each of the Federal Home Loan Banks. Until we acted on these matters, these financial institutions had operated under antiquated subscription capital rules created 67 years earlier, in 1932.

Specifically, the law now requires each Federal Home Loan Bank to submit a plan to the Federal Housing Finance Board for approval that is best suited for the condition and operation of the bank and the interests of its members. Since we completed our legislative work, all but one of the Federal Home Loan Banks have received approval from the Finance Board to put in place a revised capital structure.

A regulatory proposal put forth earlier this year by the Finance Board, however, now threatens to slow the progress being made to implement these statutorily required capital reforms. Specifically, this proposal would impose inflexible minimum retained earnings levels at each bank. This proposal has generated an extensive policy debate.

Ultimately, the Finance Board received 1,066 letters on its rulemaking plan. Less than one half of one percent of the commentators, as I understand, supported the regulatory change. Some of the key arguments raised against the plan include that it could result in a decision to engage in higher risk activities and that it could undermine the housing mission of the system. Standard & Poors has also observed that the proposal may "reduce the financial flexibility" of a bank to manage its capital positions and lessen the attractiveness of membership in the system.

While I share these apprehensions, I am most concerned about the failure of the Finance Board to conform this regulatory proposal to the specific capital statutory requirements outlined in H.R. 10. This plan would impose a uniform retained earnings requirement that every bank must adopt, regardless of its preferences.

While the law mentions retained earnings as one source of capital, it does not mandate that a bank hold a specific minimum level. In fact, as I noted in my remarks on the conference report on H.R. 10, our goal was to create "a flexible capital structure."

In a recent letter sent to Chairman Oxley and Ranking Member Frank, today's witness suggested the Finance Board's proposed capital revisions "satisfies the intent" of H.R. 10. As an author of these provisions, I must take exception to this conclusion. Our intent in updating the capital structures used at each of the banks was not only to create a more permanent capital system, but also to provide maximum flexibility to each of the banks to develop their own capital structures to address their own special needs.

Because the retained earnings proposal decreased such flexibility, it is inconsistent with the language of the law and the legislative history. In my Floor statement on H.R. 10, I also noted that I had worked to ensure that we "would not place small financial institutions at a competitive disadvantage." This regulatory proposal, in my view, would undercut our hard work to achieve that important objective.

A study of the Stanford Washington Research Group found that the proposal would disproportionately affect smaller publicly traded financial institutions. These entities would not only experience decreases in dividend income during the transition period, but unlike large financial institutions, they would also be unable to tap into our capital markets via other financing mechanisms.

Beyond my strong reservations about this recent rulemaking proposal, I continue to be concerned about the failure of the Finance Board to follow the clear statutory mandate regarding the appointment of public interest directors.

Section 7 of the Federal Home Loan Bank Act indicates that at least six directors on each bank board "shall be appointed" by the regulator. As you know, Mr. Chairman, I have a very strong interest in ensuring that the Federal Home Loan Banks benefit from an independent public voice on their boards.

Inexplicably, at least 70 percent of the public interest director positions are currently vacant. If the Finance Board fails to act on these matters by the end of the year, there will be no public interest directors at any Federal Home Loan Bank, and 40 percent of all board positions will be vacant.

These vacancies occur at a time when the system is addressing increasingly complex issues. They also create corporate governance problems, in terms of workload of the remaining elected directors, institutional memory of the board, and ensuring that the Federal Home Loan Bank adheres to the system's mission to promote affordable housing and advance economic development.

Before I close, Mr. Chairman, let me make a point to our witness. I seem to detect that there must be a signing statement written by the President when he signed H.R. 10—not this President, but the previous President—that exempted the President and this board from this law, because it seems to me the Finance Board is acting in direct contradiction of the law as enacted by the Congress. And I find that incredible, but rather consistent with this President's intent.

And I think it is very important that the Finance Board explain to this committee why you think that the action of Congress should be absolutely ignored, and that 40 percent of the members of the boards of directors of this huge institution involving billions of dollars, and with the support of the taxpayers' money behind it,

should go improperly governed. So, I look forward to hearing that answer.

In closing, Mr. Chairman, I have deep reservations about the retained earnings rulemaking as proposed by the Finance Board. I also have great apprehension about the continued failure of the Finance Board to appoint public interest directors. I, therefore, hope our witness today will forthrightly inform us about what he is doing to resolve these problems.

Chairman BAKER. I thank the gentleman for his statement. I now recognize Chairman Oxley. I don't know with certainty whether the committee will meet again in this session on the matter of GSE governance. So, accordingly, I want to express my appreciation to the chairman for his long-standing work on the creation and adoption of H.R. 1461, the House-posed position on GSE governance.

It is clear to me that we wouldn't be where we are today—although we haven't crossed the goal line—without your hard work and commitment to that purpose. So I thank the chairman for his good work, and recognize him for such time as he may consume.

The CHAIRMAN. I thank Chairman Baker for those words, and would certainly echo his remarks regarding GSE reform. The package that we passed in this committee, and on the House Floor by a large bipartisan vote, is indicative of the hard work you have done over a number of years—in many cases, all by yourself—and it would be a shame to come this far, and not put that across the goal line and get a Presidential signature on it, in light of all of the revelations that have come out on the GSE's.

It truly provides an opportunity for the Congress to put its imprint on a very important piece of legislation that you have worked on for so long. So anything we can do to that end would be appreciated.

Let me welcome Chairman Rosenfeld. It is good to have you with us, and thank you for the job that you are doing. We thought it was important to have you here to discuss some of the issues that were raised in the remarks by the gentleman from Pennsylvania, as well as the gentleman from Louisiana.

The Federal Home Loan Bank System has been critical to the country in creating a liquid residential mortgage market. The Bank System also plays an important role in small business financing and the funding of affordable housing and community investment programs.

From a Congressional standpoint, ensuring the safety and soundness and mission performance of the Federal Home Loan Banks has never been more important. I want to thank Chairman Baker for holding this hearing, and for his continued strong oversight of the housing GSE's and their regulators.

The Finance Board required the Federal Home Loan Banks to register their stock with the Securities and Exchange Commission, in the belief that greater public disclosures would be beneficial. I am interested in the status of that registration, the process, and related accounting reviews. Sound corporate governance is critical to the function of any enterprise, as we found out recently.

In this regard, I am concerned that the Home Loan Banks do not have full boards of directors. I would like to know why there has

been a delay in appointing public interest directors, and what reforms to this process, Chairman Rosenfeld, that you might support. Again, I echo the comments of the gentleman from Pennsylvania in that regard.

The Finance Board has issued a proposed rule prescribing a minimum amount of retained earnings for each bank, and limiting the amount of excess stock that a bank can have. As Mr. Frank and I stated in a recent letter to you, Chairman Rosenfeld, the potential impact of this proposal is vitally important to the banks, to their members, and to the housing finance system.

We are concerned that the proposed changes may go too far, and actually harm the bank system more than protect it. And I appreciated your response, that the Finance Board is taking an open minded and cautious approach to this rulemaking, and that any further actions will take into account the consequences for the banks and their members. I look forward to an exchange of views today on this important subject. And indeed, this is how the process works, in terms of our oversight responsibilities, as well as your responsibilities as chairman.

To that end, clearly the inclusion of the Federal Home Loan Banks in the overall GSE legislation was timely and important, and I want to say to the Federal Home Loan Banks in general thanks for your cooperation in this. I know it wasn't easy, but it clearly made eminently good sense to include the Federal Home Loan Banks under this legislation.

Once we were able to work out the difficulties, which are always inherent in the legislative process, I think the Home Loan Banks are well positioned in this proposal. This is another reason, Mr. Chairman, why we need to get this bill across the goal line to the President's signature this year, before we adjourn. And to that end, we again pledge our best efforts. With that, I yield back.

Chairman BAKER. I thank the chairman. And recognizing Ranking Member Frank, I also want to express to him my appreciation for his courtesies in working with us and moving forward on H.R. 1461, and express my hope that we are able to continue that good work, and get to conference before the year is out. And with that, I recognize the gentleman for such time as he may consume.

Mr. FRANK. I appreciate the chairman's good words, and I do want to—I think we work well together, and I hope we can continue and not give up on this. And I do want to say, in particular, I'm not used to being thanked for my courtesy, so I'm especially grateful for that.

[Laughter]

Chairman BAKER. It was particularly notable to me, so I wanted to make sure I did it.

Mr. FRANK. That's right. Okay. I think, with whatever intentions, Mr. Rosenfeld, you have made a great mistake. And I hope that we can hold off on this.

The chairman and the ranking member of the subcommittee mentioned a very serious issue for many of this, the failure to appoint public members. Now, when I raised that issue, I was told by Assistant Secretary Henry in a letter that the reason for not appointing the public members was the pendency of the GSE bill.

And he said, "Well, maybe it doesn't make sense, given the GSE bill pending."

Well, that implies, it seems to me, a—the GSE bill creates a new structure for precisely, among other things, the subject you are dealing with. And I think a rush to judgement on this now, before we get the GSE bill, is a mistake. And when I am told that you can't have members appointed by the Administration because the GSE bill is pending, but then if you were to go ahead with this, the contradiction would have to lead me to believe that something else was at stake.

Now, one of the things I asked to put in the record here, Mr. Chairman, is a letter to the Housing Finance Board under the public comments section, July 11, 2006, from a very large coalition of groups concerned with housing. From advocacy groups to builders to public officials, it includes, for example: The American Association of Homes and Services for the Aging; The National Low Income Housing Coalition; The National Association of Local Housing Finance Agencies; Habitat for Humanity; and The National Indian Housing Council. And they asked the board to shelf this, because of the negative impact it would have, as proposed, on housing. And I ask that this be put in the record.

I also ask, Mr. Chairman, that we put in the record your quotations from the Standard & Poors study on this in July. A heading of one subsection, "The new regulation poses inherent conflicts with the core business of a Federal Home Loan Bank," that's from Standard & Poors. And Standard & Poors' conclusion is, "Should this proposed regulation be adopted as it is currently written, Standard & Poors will have to monitor any negative impacts to the liquidity profile of the individual bank's core business growth dynamics and membership trends." It's a very negative analysis of this.

Obviously, we want to protect safety and soundness. We are, in fact, hoping to get a bill passed that will enhance the ability of the regulators to do this. But this does not appear to be justified by any factual basis for concern. And it is very likely to have negative effects on membership, and particularly on the affordable housing program.

Now, the affordable housing program is about 20 years old. The affordable housing program is one of the few programs we now have that helps build housing. It has been very well run. I think it is the model for what we ought to be doing with Fannie Mae and Freddie Mac. Everyone concerned about it sees a very strong likelihood of a negative impact in the affordable housing program from this program.

Now, I appreciate the fact that you tried to put some more flexibility into that, and you were responsive to concerns I made, and I thank you for that, for the question of not being so geographically bound. I appreciate that. But helping it become more flexible, if it is diminished overall, is a mistake.

So, if there is a need for some increased capital here, let's have a better justification. And I am afraid this is an across-the-board approach that will have negative consequences. I think, insufficiently, it reduces the incentive for them to differentiate between

activities that have different degrees of risk. It tends to lump things together, so that is reduced.

And the overall issue to me is that it is a proposal to cure a problem the existence of which hasn't been documented. And it's a cure that will damage many of the ongoing activities here.

I know we have had problems with Fannie Mae and Freddie Mac, and we are trying to resolve them. And we did agree to also include more authority over the Home Loan Banks. But this appears to be motivated, in part, by a kind of general skepticism of the enterprise, unjustified by any reality that we have seen.

And, yes, we want to be safe. But not to the point where we do things not dictated by any, I think, reasonable fear that will diminish the very important function. Look, we are in a situation now where the last thing this country needs from the macro-economic standpoint as well as the micro standpoint, is further damage to the housing industry. Everybody now acknowledges that the housing industry, which had carried the economy to some extent, is now becoming a potential source of trouble.

To promulgate a rule that would cause all kinds of concerns about the viability of the housing industry at this time is about the last thing we ought to be doing. And I would hope that the board would withdraw this. We are certainly available to talk. If there is a need for more specifics, let's look at it.

At the very least, the rationale that says we can't appoint public board members until the GSE bill's fate is decided certainly applies heavily to this. And I would hope we would have, accordingly, the Board act that way. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman for his statement. Mr. Royce?

Mr. ROYCE. Thank you, Chairman Baker. I want to thank you for holding this hearing, and I would also like to thank Chairman Rosenfeld for his appearance, and his testimony here before us today.

Over the past 6 years, under Chairman Mike Oxley's leadership, this committee has held a number of very important oversight hearings, and this is no exception here today. As one of the largest financial institutions in the United States, and frankly, as one of the largest borrowers in the world, the Federal Home Loan Bank System plays a very significant role in the U.S. housing finance market.

And I have particular questions about some recent regulatory actions taken by the Federal Housing Finance Board. And more specifically, I am interested in learning more about the Finance Board's thinking and its rationale behind the recent subordinated debt offering at the Federal Home Loan Bank of Chicago, and also the proposed rule to increase retained earnings at the 12 banks.

I am concerned about recent Finance Board action that has allowed the Federal Home Loan Bank of Chicago to use subordinated debt in determining compliance with its regulatory minimum capital requirement. It is my understanding that this waiver was granted so that $1 billion in subordinated debt offering could enable the Federal Home Loan Bank Chicago to redeem stock of withdrawing members, which has the effect of substituting equity capital with debt capital.

I am interested to know if this regulatory forbearance is not only unnecessary, but also if perhaps it is inconsistent with the statutory minimum capital requirements this committee passed in title six of Gramm Leach Bliley.

Additionally, I think this committee and the public needs to learn more about how this subordinated debt offering could affect the joint and several obligations of the Federal Home Loan Bank System, as a whole.

As to the retained earnings proposed rule, while I understand the intent behind the Finance Board's desire to increase the retained earnings at each of the 12 banks, it is not evident how the Finance Board arrived at some of the proposed rule's specific requirements.

For example, the rule would require each Home Loan Bank to hold retained earnings of at least 1 percent of non-advance assets. However, it is not clear to me how or why the Finance Board arrived at the 1 percent figure. Perhaps the 1 percent number is a good target, but I think it would be helpful for the committee to have an understanding as to why the Finance Board believes each bank should be required to have that specific mix of regulatory capital.

Mr. Chairman, I would like to thank Chairman Rosenfeld for his willingness to engage the committee today. And I yield back.

Chairman BAKER. I thank the gentleman. Ms. Hooley?

Ms. HOOLEY. Thank you, Mr. Baker, for holding this hearing, and for all that you have done on GSE reform. And I thank the chairman and Ranking Member Kanjorski for holding the hearing today.

Like my colleagues, I have some concern about the proposed retained earnings rule for the Federal Home Loan Bank System, both in terms of the rule, and in the process. My primary concern is regarding the necessity of the rule. When the board just recently approved capital plans for the 12 Federal Home Loan Banks, if these capital plans were not sufficient to protect the soundness of the Federal Home Loan Bank System, it seems to me they should not have been approved by the Finance Board.

As the board stated in its proposal, the system is well capitalized, and the risk of insolvency for any Federal Home Loan Bank is remote. So my question—is the rule necessary?

Furthermore, the Finance Board did not use an advance notice of proposed rulemaking, and instead, issued the proposed rule without feedback from the various stakeholders of the Federal Home Loan Bank System. As a result, the Finance Board received over 1,000 comments in response to the proposed rule, almost all of which were strongly opposed.

When there are so many concerns about the impact of the rule—and it is clear that this is not an immediate pressing issue—it seems to me that an advance notice of a proposed rulemaking is a better way to address the issue, which would allow for an increased dialogue amongst the board, the Federal Home Loan Banks, their member institutions, and interested members of the public, all of which should have, I think, a voice in the process.

Finally, I have concerns about the possible impact of this proposed rule, not only on the Federal Home Loan Banks, but the

member institutions and the communities they serve. Under this rule, the Federal Home Loan Banks will have to increase retained earnings by over $3 million over the next 18 to 36 months, and that is just an average amongst the banks.

In the case of the Seattle Home Loan Bank, it may take as much as 10 years for them to reach the required retained earning minimum. Because of the requirement to dividends, when a Federal Home Loan Bank does not have the required retained earnings, the member institutions will suffer from the loss of income.

Larger member institutions may even seek out alternatives, and reduce their use of the Federal Home Loan Bank, all together. As the Federal Home Loan Banks face a reduction in earnings, it will also lead to reductions in the funds available for the affordable housing program.

In light of the concerns with the proposed rule, both in terms of its likely effect on both the Federal Home Loan Banks themselves and their member institutions, I think this is an issue that certainly merits further consideration. And we should ensure that all the concerns of the stakeholders have been reasonably addressed before moving forward with the rule, so I just want to have more people involved in the process.

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

Chairman BAKER. I thank the gentlelady. Mr. Hensarling? No statement? Mr. Castle? Ms. Biggert? In that regard, Mr. Moore? Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman. Chairman Baker and Ranking Member Kanjorski, I want to express my sincere appreciation for you holding this hearing to review the status of the Federal Home Loan Banks, and the activities of the Federal Housing Finance Board today.

I have a long statement, and I would ask unanimous consent that it be included in the hearing today.

Chairman BAKER. Without objection. And by earlier request of Mr. Frank for inclusion of his additional documents, that is also included without objection.

Mr. HINOJOSA. Thank you.

Chairman BAKER. Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman. I will submit a statement for the record, but just want to thank you for holding this hearing today, and express my concern about the proposed rule, and the impact it would have across the country to the different regions, and hope that this is the first of more hearings, Mr. Chairman, on this proposal. Thank you.

Chairman BAKER. I thank the gentleman for his statement. Mr. Scott?

Mr. SCOTT. Yes, thank you, Mr. Chairman. I appreciate this opportunity. I have some very serious concerns about the proposed rule. The Federal Home Loan Bank in Atlanta, and all the 12 others across this country, are doing a tremendous job, particularly in providing affordable housing funds.

Now, I think it is very important that we understand an important aspect that—as background. The members generally own capital stock in the banks, in proportion to the amount of their busi-

ness. Bank stock is not publicly traded. Members buy and sell it at a fixed par value of $100 per share. And the member stock provides the capital needed to operate the banks in a safe and sound manner.

Now, as I understand it, your proposal, Mr. Chairman, asserts that banks could incur losses, and that any loss in excess of a bank's retained earnings would require members to mark down their bank stock below par value. Thus, in order to protect the par value of member stock, the board has proposed requiring the banks to keep retained earnings equal $50 million plus 1 percent of total assets minus advances, correct?

The banks would have to cut dividend payments in half, until they met the new retained earnings requirement. Such a rule, Mr. Chairman, would make doing business with banks much less attractive to member institutions, and would dramatically reduce bank profits and dramatically reduce the affordable housing funding, which is vitally, vitally important.

Now, my concerns are thus; the need for the proposed rule definitely has not been established. The premise that the par value of bank stock must be protected at all costs is incorrect. In accordance with current accounting policy only, "other than temporary impairment" would require a write-down of member stock.

There has never been such an event in the entire history of the Federal Home Loan Banking System, and the Board has not predicted one. And in proposing to change the capital rules for the bank, your Finance Board itself acknowledged that all the banks are well capitalized and they face no threat of insolvency. And even if additional capital in the form of retained earnings is appropriate for some banks, the proposed formula is overly simplistic, and does not take into consideration the specific risk and risk management policies and policies of each bank.

The proposed formula creates a retained earnings to target that seems excessive in relation to the risk to the par value of capital stock for most banks. And the proposed retained earnings rules formula creates incentives for the banks to take on more risk and reduce liquidity.

This proposed rule has the potential to create instability within the system by causing some members to leave the system, or at least reduce their use of advances significantly. If that happens, as I said, bank profits and the affordable housing funding would decline dramatically.

The proposed rule is not consistent with bank capital requirements as established in Gramm-Leach-Bliley. The appropriate way to address capital concerns is not this way, perhaps to modify bank capital plans. There is no justification for this proposed regulation.

Even if it were demonstrated that there are problems that need to be addressed—and you all haven't even demonstrated that—but even so, there are far more effective ways to do that without driving down the available housing funding.

This proposed regulation has serious adverse consequences for the banks, their members, and the system of their respective communities. I would hope we reject this. I hope we would withdraw this. I think it is bad policy for our banking system, and would hurt the affordable housing funding dramatically.

I look forward to your comments on this, and I have some very, very significant questions I would like to address to you at that time.

Chairman BAKER. I thank the gentleman. If there are no further opening statements at this time, I would like to recognize the Honorable Ronald A. Rosenfeld, Chairman of the Federal Housing Finance Board, welcome you here to the committee, and express my appreciation for your hard work and diligence in establishing a new regulatory regime. Please proceed as you see fit.

STATEMENT OF RONALD A. ROSENFELD, CHAIRMAN, FEDERAL HOUSING FINANCE BOARD

Mr. ROSENFELD. Thank you, Chairman Baker, Ranking Member Kanjorski, and distinguished members of the subcommittee. I appreciate the opportunity to testify on the Federal Housing Finance Board and the Federal Home Loan Bank System by testimony, reports on the condition and performance of the banks, the operations of the Finance Board, the status of two supervisory actions, and two key regulatory initiatives.

I want first, however, to stress the need for reform of the regulation and supervision of the housing GSE's. Fannie Mae, Freddie Mac, and the 12 home loan banks are large, complex entities. They are important to the Nation's housing market and play a vital role in the financial markets. They should be overseen by a single, strong, and independent regulator that has a full arsenal of supervisory and enforcement tools.

The combined assets of the 12 banks exceed $1 trillion. If the Federal Home Loan Bank System was a bank holding company, it would be the fourth largest bank holding company in the country. Advancers are the largest asset class, consisting of 62 percent of assets. The top 10 holders of advances account for 33 percent of the total system advances.

Mortgage purchases are even more heavily concentrated than advances. Mortgage loans purchased from members constitute 10 percent of assets. Almost 70 percent of the mortgages in the system were purchased from 10 members. The total capital of the banks is $45.5 billion, or 4.4 percent of assets. Of that total, retained earnings are $3 billion.

In the first 6 months of 2006, the banks' net income was $1.25 billion. The banks have grown in size, sophistication, and risk in recent years. Many of the banks were not equipped to deal with those changes. They did not embrace and implement appropriate governance and risk management tools.

Two examples are the Seattle and Chicago banks. The Seattle and Chicago banks continue to operate under written agreements. While the particulars of each case are different, both had a high level of excess stock, and both were intent on growing their mortgage portfolios. The Chicago bank grew its mortgage portfolio by relying on excess stock. The Chicago bank's mortgage portfolio grew to 60 percent of assets and excess stock constituted approximately 60 percent of its capital stock.

When the Chicago bank's earnings declined and dividends were reduced, as one might expect, member requests that the bank repurchase excess stock accelerated. To conserve its capital, the bank

halted its repurchase of stock. In response, members holding over a quarter of a billion dollars in stock elected to withdraw from the bank. That process began a 6-month statutory redemption clock. We then had to act decisively and quickly.

There were no easy options. The Chicago bank, unlike Seattle and the other 10 banks, had not yet converted to the Gramm-Leach-Bliley capital structure. After reviewing a number of alternatives, we permitted the Chicago bank to issue subordinated debt. The bank issued $1 billion in 10-year subordinated debt, which is used to retire a like amount of excess stock that was redeemable with 6 months notice.

That solution provided the Chicago bank's new management team time to work through and resolve the bank's financial issues. We have learned from our supervisory experiences. We have also increased the supervisory staff, and upgraded our risk modeling technology. We now have the resources to better monitor risk, and the wherewithal to take early and resolute action where problems emerge.

We have also taken a number of important regulatory actions. One of these is our rule requiring the banks to register with the SEC. All banks are now SEC registrants. Investors, other home loan banks, and the public now have a full and fair view of the financial condition and performance of each of the banks.

A second regulatory action is our proposed rule on retained earnings and excess stock. In April of this year, the Finance Board issued for public comment a proposed rule to strengthen the capital composition of the banks. We are analyzing the 1,066 comments we received, and are taking an open minded and cautious approach to the final rule.

We will be guided by some fundamental principles. Specifically, we will do nothing to impede the good business judgement of the banks. We will not materially alter the value of membership in a bank, we will respect the lawful actions that banks have previously taken.

Speaking only for myself, some commentators made valid points, and there is room for movement on several important issues. I want to be clear. I will never be apologetic about capital. While the capital level of the banks exceeds the 4 percent statutory minimum, the composition of the bank's capital needs to be strengthened. That's the purpose of our proposed rule.

Some comments state that that proposed rule is contrary to the statutory intent of Gramm-Leach-Bliley, and that we have exceeded our regulatory authority. We strongly disagree. The intent of Gramm-Leach-Bliley was to stabilize and strengthen the capital of the banks. Our proposal does exactly that. The rulemaking is fully consistent with our regulatory authority, and is an exercise of our regulatory duty. It is our duty to ensure the financial safety and soundness of the banks, a duty entrusted to us by this Congress.

Chairman Baker, Ranking Member Kanjorski, and the members of the subcommittee, thank you for the opportunity to report on the condition of the Bank System and the Federal Housing Finance Board. I would be pleased to respond to any questions.

[The prepared statement of Chairman Rosenfeld can be found on page 36 of the appendix.]

Chairman BAKER. Thank you, Mr. Chairman. I appreciate the manner in which you have approached this regulatory proposal, and certainly can understand how a GSE regulatory concept and controversy could be associated with one another.

You could, in some instances, erase the name, "Federal Home Loan Bank," and put the words "Fannie Mae" and "Freddie Mac" in, and play back a few years ago, and it would not be too dissimilar.

However, there is one element of the proposal that I found particularly interesting, if not troublesome. And that is, with regard—if I am understanding it properly—with regard to the holding of cash to require reserving, if you had $100, to reserve against that $100 in your account, is there a particular structural regulatory reason why reserving against cash on hand, which I thought would be a bit onerous?

On the other side of the coin, however, not stated in most of the talking points distributed by the opponents of the matter, but expressed to me by intermediaries, and just—I find on these GSE things, you might as well just get it all out on the public domain—that some are suggesting there are other reasons, other than just capital adequacy, for the proposal of the current rule.

Some have suggested this is just a first step for some sort of consolidation proposal. Others are more direct, in calling it just an attack on their profitability through the mortgage purchase program.

If you could, just outline your policy reasons for the proposals construct. I think in your opening statement you referenced the necessity for adequate capital to hedge against any identifiable risk.

But that ought to—we ought to dismiss these other accusations outright, or discuss the legitimizing reasons for the manner in which you're approaching this. And please proceed as you desire on those.

Mr. ROSENFELD. Chairman Baker, you have given me a smorgasbord of possibilities, in terms of responding to the—to elements of the proposal. Let me attempt to deal with them as I recall them being raised.

With regard to the commonality of the same retained earnings for all types of assets, other than advances. That is an area that we have received a great many comments on, and something that we are carefully considering.

In the course of receiving comments, we have been apprised of some things relating to that concept, which is—certainly provides the benefit of simplicity. But it also has the potential of perhaps adversely affecting prudent business judgement. And therefore, it is something that we need to look at very carefully, as to whether we ought not apply some degree of risk weighting to various types of assets. And that is clearly one of the things that has been raised.

While I am on areas that have been commented upon extensively, the other areas, though, one is the area of stock dividends. A number of people have said, "Well, if you're going to limit excess stock, why limit how you get there? I mean, just stick with one objective, and that ought to be enough." And besides, some of the banks rely heavily on excess stock—pardon me, on stock dividends.

The third area that has received a great deal of comment and has been referenced by a number of your committee members is

this issue about until they reach a required level of retained earnings, dividends can be no more than 50 percent of income.

Again, that is an area that—where the comments have been extraordinarily helpful, because a number of commentators have suggested that as long as there is no particularly urgent issue in the system today, it need not be so difficult, and the banks ought to have more time to get there, which raises an absolutely remarkable point, and that is there are 12 Home Loan Banks in the system. Eight or nine of the banks, in terms of the retained earnings requirement, are at or very close—within a stone's throw—of being there.

So, this notion of how Draconian it is, is simply nonsense. Eight or nine of the banks are there, or will be there very shortly, without doing anything. In addition to which, the other Draconian allegation that was made towards this limit on excess stock, 8 of the 12 banks are there now. And one or two are very much on their way.

So, the impact—this enormously broad opposition throughout the country and all the banks simply doesn't exist. It is absolutely nonsense. And let me point out to you that on the issue, for example, the issue of excess stock, which is one of the pillars of the proposal—we've got 400-some letters, comments, on that issue—81 percent of the letters came from the Cincinnati Bank.

And throughout the entire comment period, what has happened is that the vast majority in virtually every single category has come out of the Cincinnati Bank. That's not to suggest the comments from the other banks are not important; they are very important. And quite frankly, they are very helpful. I just wanted to convey to you the fact that this is—that there is not this enormous outpouring of opposition throughout the country. It largely emanates from a campaign by the Cincinnati Bank. And we respect that, there is nothing wrong with that.

With regard to the issue that we have in the ulterior motives, I have heard a couple of them alleged. Number one, is this our way at getting at the mortgage programs? The answer is absolutely not. If we decide to take some action with regard to the mortgage program, believe me, Mr. Chairman, we will take it directly. We will never go through the back door, we don't need to. That's not the way to regulate.

Number two, the issue of consolidation, which has been raised frequently. The answer to that is we have stated publicly that we have—we are not promoting the consolidation of banks. We have said if two or more banks decide they want to merge, we will be cooperative and help them do it.

Quite frankly, in my mind, I don't quite understand why you need six banks between Pittsburgh and Topeka. But if that's what the members want, and that's what the members are willing to pay for, and they run those institutions in a safe and sound fashion, that is their prerogative. It is not our call to change, and we have no intentions of changing.

And quite frankly, Mr. Chairman, my memory at my age is—I can't remember some of the other issues, but if you could help me out—

Chairman BAKER. No, you have done an excellent job. One, your intention is to provide safety and soundness, providing a capital basis which you believe is justifiable. You don't have ulterior motives in mind that you are attempting to achieve. You perhaps will consider further adjustments to the pending rule, and you will not move and give adequate time for people to make further comment as warranted. Is that summarized properly?

Mr. ROSENFELD. Yes, sir.

Chairman BAKER. Thank you very much. Mr. Kanjorski?

Mr. KANJORSKI. Mr. Rosenfeld, in an article this morning, in one of the banker's publications, they refer to the fact that Washington Mutual is—in regard to the ruling, because of the cost to them of the retained earning role, it would cost them $210 million. They are going overseas to finance.

Now in my prior life as an attorney, I represented co-ops, and I very often found that members of co-ops are very astute in figuring out the effect of the co-ops' policies upon their particular earnings. And this is a strong indication that they are voting with their feet. They have other alternatives; they can go overseas. So I don't know whether it is—for safety and soundness—it is smarter to drive a customer, the largest customers to the banks of the System, to go overseas and do their financing.

And that is why I think it's important that—and I can understand why we want to get safety and soundness, there isn't any question of that. But the implementation of these rules, or the inflexibilities of the rules, may cause unintended consequences of actions just like this.

I don't want to dwell on that because I think the chairman's questions and your response served a lot of those purposes.

I really want to find out about something that is—it's sort of offensive, because I was under the impression when we have met in the past, that you were going to be a hands-on regulator. You were going to get out into the field, and find out what is happening. Have you gone and met with the boards of directors of the various banks, and—

Mr. ROSENFELD. I have not gone to the banks. I have met with them, met them here in Washington.

Mr. KANJORSKI. Are they telling you something different than I am hearing, that they are being literally choked by not having adequate membership on—

Mr. ROSENFELD. Oh, quite the contrary, Mr. Kanjorski. I have had very little comment from the banks. As a matter of fact, with the exception of some issues with regard—a couple of banks have mentioned a problem with staffing committees on the bank board. But beyond that, there has been very little—surprisingly little—commentary from the banks.

Mr. KANJORSKI. Do you know what some of the banks are doing, as a result—

Mr. ROSENFELD. Well, I know what the Pittsburgh bank has done, and that is they have gone out and where one might have hoped that they had certain talent that was in the form of public interest directors with certain skill sets, since they don't have that, they have gone out and hired consultants, which is an interesting approach.

Mr. KANJORSKI. And they're the same people who would have been serving on the Board—

Mr. ROSENFELD. Not necessarily. The people—the most well qualified don't necessarily get on the Board.

Mr. KANJORSKI. Well, then, is your hesitancy in making these appointments that you think the Administration is not offering competency in the appointment of these directors?

Mr. ROSENFELD. No, no, no. I am responding to the difference between the expertise of a consultant—

Mr. KANJORSKI. I understand. But—

Mr. ROSENFELD. And—

Mr. KANJORSKI. Mr. Rosenfeld, I have extraordinary contacts with all of these banks across the country, and I visit with them on a regular basis.

Now, either they are not talking to you the way they are talking to me, but I have to tell you that, internally, for governance purposes, they are hurting. And their institutional memory is suffering. I think that the majority of the members at the end of this year will have less than 3 years' experience on the board.

Mr. ROSENFELD. I respect that, Mr. Kanjorski. I understand what you are saying, and I respect it. But please, let me comment on one thing you said earlier, with regard to Washington Mutual.

Mr. KANJORSKI. Yes.

Mr. ROSENFELD. Interestingly enough, I would suggest that the proper interpretation of their action is just the converse of what you are suggesting. And the reason that—well, I am sure one of the very significant reasons that WAMU is seeking to withdraw, or at least do less business, with the Home Loan Bank System is their experience in Seattle.

Seattle is a terrible situation for WAMU, because they are getting—they have a big presence, and they are getting zero dividends. The reason they are getting zero dividends is because we did not have in place the rules that we are now trying to put in place. WAMU would have a totally different experience with the Home Loan Bank System, had Seattle not succumbed to the problems that they—

Mr. KANJORSKI. Well, aren't they a member of another bank, the San Francisco—

Mr. ROSENFELD. They are a member of the San Francisco—

Mr. KANJORSKI. Why don't they go to the San Francisco bank?

Mr. ROSENFELD. I think the San Francisco bank, to my knowledge, they have not had a bad experience there. And I don't think you can contribute—with an organization as big and sophisticated as WAMU is, or Wells Fargo, or Bank of America, they have all sorts of reasons for how they fund their needs.

And we certainly can't blame a decision to go overboard or go to the private sector, or whatever, on the—

Mr. KANJORSKI. Okay. I accept that, and we will have to look at that maybe in a future hearing. We can call Washington in to explain why they made these judgements. But I am seeing a lot of business here move overseas that could be in the American market.

But getting back to the directors, what does the Congress of the United States have to do? The present law says it is your responsibility to make these appointments. You have refused to do so.

I have to ask the question, are you an independent regulator, as you have defined it, totally at arm's length with the industry, and totally independent of all other influence, or are you failing to carry out these appointments by some statement or conversation with the White House, whose policy is not to make these appointments? Are you failing to carry out your function as a regulator independently, because of something this White House is telling you to do?

Mr. ROSENFELD. I believe that we are an independent regulator. I also believe that it is inappropriate for a regulator to appoint the regulated.

Mr. KANJORSKI. Oh, you disagree with the law, then?

Mr. ROSENFELD. I think a regulator should not appoint the regulated. I am aware there is a statute. I believe, however—

Mr. KANJORSKI. Mr. Rosenfeld, you mean the regulator now is going to pass and interpret the laws governing these banks, or is the Congress—

Mr. ROSENFELD. I think the statutes are such, the latitude, in terms of time, as to when to appoint, while the issue of GSE reform—which has been referred to numerous times today—

Mr. KANJORSKI. Mr. Rosenfeld, 2½ years, not one independent director to any of the banks has been appointed by your office or your predecessor. Is that correct?

Mr. ROSENFELD. That is true. I believe the real answer is to have GSE reform.

Mr. FRANK. Will the gentleman yield?

Mr. KANJORSKI. I will yield, Mr. Frank.

Mr. FRANK. Again, Mr. Rosenfeld, it is—first of all, the suggestion that consultants can make up for boards of directors, and that it is somewhat interchangeable—

Mr. ROSENFELD. I'm sorry?

Mr. FRANK. I hope you don't really think, really mean to say, that you can solve a problem of not having an appropriate board of directors by hiring consultants.

Mr. ROSENFELD. I didn't—

Mr. FRANK. Yes, you said, "Well, they lost the expertise."

But secondly, this assertion that you can't appoint directors because GSE legislation is pending, but you can promulgate the most far reaching change in the capital structure when that's also the subject of GSE legislation, that's the least logical argument I have ever heard here.

Chairman BAKER. If I might interject here, gentlemen, just for the moment—Mr. Kanjorski, we are down to a little over 3 minutes on the pending vote. We are going to recess and come back to continue. So if I may ask the indulgence of the chairman, the committee will stand in recess for about 15 minutes.

[Recess]

Chairman BAKER. I would like to reconvene our hearing on capital markets. When we were last meeting, I believe it was Mr. Kanjorski who had been previously recognized. So I would now go to the Republican side, and recognize Ms. Kelly for any comment or question she may have.

Mrs. KELLY. Thank you very much, Mr. Chairman. In its proposed rule concerning deposit insurance assessments that was published on July 24th, the FDIC specifically requested comments on

whether the Federal Home Loan Bank advances should be included in the definition of "volatile liabilities" for risk differentiation purposes for smaller institutions with less than $10 billion in assets.

Frankly, I don't see a need for charging higher premiums for prudently managed and sufficiently capitalized institutions, simply because they use the Federal Home Loan Bank advances. Advances are not volatile liabilities. Of the sources available to community banks, Home Loan Bank advances are the only ones which have been around for nearly 75 years, and which have been—and which are purchased on a pre-defined and predictable term by fully regulated member lenders.

Obviously, this is a matter that should be on the radar screen of the FHFB. And in this regard, I would like to know if the FHFB considers advances to be volatile liabilities. You can probably just answer that yes or no.

Mr. ROSENFELD. No.

Mrs. KELLY. Okay.

Mr. ROSENFELD. Absolutely not. I think it is a mistake to use the term "advances" and "volatility" in the same sentence.

Mrs. KELLY. Okay. In addition, is FHFB planning to take a position on the Federal Home Loan Bank issue raised in the FDIC's proposal, and notify the FDIC of its views?

Mr. ROSENFELD. I am sure that, to the extent that we are an involved participant, we will appropriately make our position known.

Mrs. KELLY. All right. Thank you, Mr. Chairman, he has answered my question. I yield back.

Chairman BAKER. I thank the gentlelady. Mr. Clay?

Mr. CLAY. Thank you, Mr. Chairman. And thank you for being here.

The affordable housing programs of the FHL Banks has been a tremendous success, with over $2 billion in grants for affordable housing since 1990. These AHP grants by FHL Banks provide capital so that member institutions and community sponsors can arrange for the development and construction of affordable housing.

At a time when more families need affordable housing, it is troubling that the Finance Board has issued a proposal whose effect on FHL Bank System, you acknowledge in your July letter to Congressmen Oxley and Frank, is uncertain. Since the AHP program depends directly on FHL Bank earnings, this is even more troubling.

What analysis has the Finance Board done on the potential impact of the proposal on the AHP program?

Mr. ROSENFELD. I am delighted you asked that question, because a number of commentators and a number of congresspersons here have made the statement that somehow or another these proposals adversely affect AHP. I would submit to you that that's simply wrong.

First of all, in both the case of the retained earnings provisions, as well as the excess earning—excess stock provisions, roughly three-quarters of all the banks simply aren't affected at all. So I think you can eliminate them from the issue of whether anything negative would occur in their AHP program.

I would also suggest that AHP contributions are based upon earnings. To the extent that you increase retained earnings, that

does not affect your income. If it did anything, it would increase the income, not decrease the income. I can think of perhaps one bank, maybe two, where the excess stock provisions would have a bearing in possibly reducing AHP payments.

But I would point out to you the worst thing that has happened to AHP, which is a wonderful program, and we all acknowledge it, has been Seattle and Chicago. That's where AHP has gotten hurt. I wouldn't want to be the person that called on Seattle to get their contribution to AHP. It's not a pretty number.

And what we are trying to do is to make sure that those kinds of things that reduce the earnings of banks and adversely affect AHP simply don't occur again. That's what this is all about.

Mr. CLAY. Let me follow up on that vein. What alternative funding source may be available for affordable housing, if FHL Bank earnings decline, as a result of the proposal?

Mr. ROSENFELD. Well, first of all, the answer to increasing AHP profitability is to increase the business and increase the earnings.

For example, there are some pending new business activities in the area of working with insurance companies, which could be the source of additional income. I think Mr. Kanjorski is familiar with a proposal to have the FHLB be able to credit enhance industrial bonds, which could be a new source of revenue appropriately—if it were appropriately underwritten.

There is—quite frankly, the Home Loan Banks have an enormous opportunity. What they need to do, as any good business does, is through the use of ingenuity and technology working together, create better products, do a better job, in terms of growing their businesses.

I would point out to you that it takes a Des Moines bank—the Des Moines bank has had a number of problems in their mortgage portfolio. They had 90 percent of their mortgages that they bought coming from 1 customer. What prudent businessperson would ever allow 90 percent of their portfolio of anything—certainly anything significant—to come from 1 customer?

Now, I would also point out that Des Moines has 1,190 other banks in the system, in their membership. Boy, I will tell you, if I ran Des Moines, I would be out trying to figure out what I could sell to those other 1,190 banks. That's how you grow earnings. It's a business.

Mr. CLAY. So, the banks should be innovative and look at new business ventures?

Mr. ROSENFELD. Absolutely. That is what I am—that's American business. That is why we are where we are. Innovation is critical.

Mr. CLAY. I thank the witness for his response, and thank you, Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentleman. Mr. Campbell, did you have—Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. Let me visit this issue of the affordable housing program. And your response to Congressman Clay's question somewhat intrigued me, when you just cavalierly passed that off. Let me tell you how I understand the impact that your ruling will have on drying up affordable housing funds.

First of all, as your rule would do, FHL Banks would be forced to retain earnings, no matter what their individual business plans or risk profiles look like, over $2 billion will be retained. And that $2 billion will be $2 billion that will not be distributed through FHL Banks' member institutions to the borrowing public.

And in addition, as the FHL Bank adjusts their business operations to take into account that some of their larger members will leave because the FHL Bank membership is no longer financially attractive—I am not saying you are intentionally trying to dry up that fund. This is unintended consequences. If your membership leaves, and is no longer financially attractive to the Home Loan Banks, then the cost of the FHL Bank advances to remaining members will increase, and members will, in turn, pass on those increased costs to working class families who are seeking home mortgages.

Now, if the FHL Bank members leave—and, indeed, they will, as you have mentioned two or three of them, but there will be more than that—another potential adverse effect of the rule that would drive affordable housing money is that the earnings of the FHL Banks will decrease, thereby decreasing the amount of funds available for FHL Banks' affordable housing programs.

Each year, the FHL Banks contribute 10 percent of their earnings as seed capital to the affordable housing program, which sponsors the local community groups, and backed financially by FHL members.

Of course, as we pointed out, since 1990 the FHL Banks have provided over $2 billion in affordable housing funds. This public/private partnership is vital to providing decent housing opportunities for working class families. And your rule, the Finance Board rule, will—and let's be generous here, and say "inadvertently"—but it will, nonetheless, restrict the ability of the FHL Banks to meet their affordable housing funding responsibilities.

To show you how serious this is, this is an article in today's paper. Here is what it says, "African Americans not closing the gap in home ownership rates." The report blames two things: discrimination and lack of affordable housing funds.

Now, it is clear, as I have pointed out, how this would work. And I don't understand why you all have not taken that into consideration, that members will leave, drying up the amount of money that is there. And even when you put the pressure on, it will be downward pressure with this $2 billion that won't be available public monies, anyway. In two ways you are taking available funds out of the market place, out of play, that would help with the affordable housing fund.

Mr. ROSENFELD. Mr. Scott, I share your obviously great interest in affordable housing. As you know—perhaps you don't know—I spent most of my Federal service at HUD, and I really do share your concerns and your beliefs in the importance of that issue.

But I would respectfully suggest that you are misinterpreting something. The amount of dividends that a bank pays to its members has nothing to do with its earnings. The contributions to AHP are made at the Federal Home Loan Bank level, which is—and that amount of contribution is determined by their income. Dividends to the members have nothing to do with it.

And I would point out, as a practical matter—and this is not a reason to make the proposal, but as a practice matter—the more retained earnings you have, which are invested, the greater your income is. So the reality is that by having more retained earnings, that in and of itself increases income—and therefore, AHP contributions—rather than decreases them.

The one comment—or, I shouldn't say one—you made a comment about major banks leaving, and therefore that could adversely affect income, and therefore adversely affect AHP contributions. Theoretically, that is possible. But both in my written statement to the committee, and my oral statement, I tried to make it very clear that one of the things we will consider in doing the final rule is that we don't materially change the value calculation for members, and we are very conscious of that.

Again, I reiterate that 75 percent of the members are unaffected. So you are talking about perhaps two banks, two or three banks, where we have to be extremely cautious and careful that, however the final rule comes out, that we don't materially adversely affect the value of membership.

Mr. SCOTT. Seventy-five percent of the banks won't be affected? One of those 25 percent affected might be my bank, the Federal Home Loan Bank of Atlanta.

Mr. ROSENFELD. I don't think so.

Mr. SCOTT. And even if it is not, if one bank is impacted by this rule negatively, it should not be in place.

Mr. ROSENFELD. If we had this rule in place 3 years ago, AHP would have substantially more money today than they have.

Chairman BAKER. Mr. Scott—

Mr. SCOTT. Yes, I want to ask another question.

Chairman BAKER. If this can be your final, we will wrap up, Mr. Scott.

Mr. SCOTT. Even if there are some Home Loan Banks with inadequate capital, your proposal doesn't appear to adequately differentiate such home loan banks from others that have plenty of capital. I mean, why not?

And how do you justify requiring the same capital for cash and cash equivalents as you require for mortgages and relatively high risk securities? And what analysis have you done to justify the proposal?

And I do understand that you were asked to disclosure your analysis before, but you refused. Why?

Mr. ROSENFELD. Well, I don't recall the specific facts, but I can't imagine I refused to disclose an analysis. I can tell you that the issue that you are alluding to, in terms of the potential risk waiting for different types of assets, I think, is an issue that has been raised by many people.

I think the notion of 1 percent for all kinds of assets needs to be seriously revisited. We intend to do so. And I think there is a great deal of merit in the—as I mentioned with the commentators, I think there is a great deal of merit in your question.

The answer is, I mean, the very simple answer is when you're doing this sort of thing we start with a very simple principle. What we have come to understand, through the benefit of the comments, is that the simple principle may be a better principle if it's some-

what more complex. And we are very concerned that the principle, as proposed in the rule simply might lead to what could be poor business judgement on the part of bank management.

And again, as I said in my testimony, that is something we clearly want to avoid. So, we are going to do whatever we can to get away from anything that would create poor business judgement on the part of management.

Mr. SCOTT. Mr. Chairman, I am going to thank you for your indulgence on that, and the question, and I certainly want to submit this very important article, very timely, about the lack of affordable housing and its impact on working class folks, for the record.

Chairman BAKER. Without objection, Mr. Scott.

And we will keep the record open, so if members choose to submit additional written inquiries of the chairman, they certainly may do so.

I want to express my appreciation to you, Mr. Chairman, for being available, for coming before the committee. It is clear that Members have a number of considerable concerns about the proposal, but I was pleased to hear your comment indicating that the rule is still subject to potential modification, that you will move ahead slowly, listening to those legitimate concerns that have been raised, and will continue to advise the committee as to the intended consequences of this rulemaking process. And for that, I am appreciative.

And thank you for your courtesy in appearing here today. Our meeting stands adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

A P P E N D I X

September 7, 2006

Opening Statement

Chairman Michael G. Oxley

House Financial Services Committee

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Review of the Federal Home Loan Bank System"
September 7, 2006

The Federal Home Loan Bank System has been critical in helping to create a liquid residential mortgage market. The Bank System also plays an important role in small business financing and the funding of affordable housing and community investment programs. From a congressional standpoint, ensuring the safety and soundness and mission performance of the Federal Home Loan Banks has never been more important.

I want to thank Chairman Baker for holding this timely hearing, in his continued strong oversight of the housing GSEs and their regulators.

I also want to welcome Finance Board Chairman Rosenfeld to the Committee this morning. It was just over one year ago that Chairman Rosenfeld last appeared before the Committee. We look forward to his update on the state of his agency and the Bank System.

The Finance Board required the Federal Home Loan Banks to register their stock with the Securities and Exchange Commission, in the belief that greater public disclosures would be beneficial. I am interested in the status of the registration process and related accounting reviews.

Sound corporate governance is critical to the functioning of any enterprise. In this regard, I am concerned that the Banks do not have full boards of directors. I would like to know why there has been a delay in appointing public interest directors and what reforms to this process Chairman Rosenfeld might support.

The Finance Board has issued a proposed rule, prescribing a minimum amount of retained earnings for each Bank and limiting the amount of excess stock that a Bank can have. As Mr. Frank and I stated in a recent letter to Chairman Rosenfeld, the potential impact of this proposal is vitally important to the Banks, their members, and the housing finance system. We are concerned that the proposed changes may go too far and actually harm the Bank System more than protect it.

I appreciated Chairman Rosenfeld's response that the Finance Board is taking an open-minded and cautious approach to this rulemaking and that any further actions will take into account the consequences for the Banks and their members. I look forward to an exchange of views today on this important subject.

Lastly, I want to reiterate the urgent need for GSE regulatory reform. The House has acted with strong, bipartisan legislation. We urge the Senate to move ahead and stand ready to complete the process, so that Congress can give the President a bill this year. The differences are few, but time is getting short. This Congress should not close without addressing the serious inadequacies of the current GSE regulatory system. We look forward to working with Chairman Rosenfeld and the Federal Home Loan Banks in pursuit of this worthy goal.

CONGRESSMAN JOE BACA
CM HEARING, "REVIEW OF THE FEDERAL HOME LOAN BANK SYSTEM"
SEPTEMBER 7, 2006

OPENING STATEMENT

Thank you Mr. Chairman. Thank you Chairman Rosenfeld for your testimony.

The mission of the GSEs and Federal Home Loan Banks is critical especially as it relates to financing affordable housing for low-and moderate income families.

In Southern California housing costs have skyrocketed. Many families have moved to the San Bernardino area where housing is considered less expensive. But even here, we have seen home prices rise quickly, and I am concerned that many working couples cannot afford a home.

The Affordable Housing Program of the FHLBanks has been a tremendous success, with over $2 billion in grants for affordable housing since 1990. These AHP grants by FHLBanks provide seed capital so that member institutions and community sponsors can arrange for the development and construction of affordable housing.

My district has received $1.6 million in AHP grants which have financed affordable housing for 443 seniors and low income families that live withint the Inland Empire.

It is my understanding that the Finance Board has received over 1,000 comment letters on the proposed rule and that almost all of these comments are in opposition.

At a time when more families need affordable housing, it is troubling that the Finance Board has issued a proposal whose effect on FHLBank System earnings "is uncertain." I am concerned that if FHLBank earnings decline as a result of this proposal, there is a real risk that funding for affordable housing could also decline.

I hope some of these questions will be answered during today's hearing, but given these risks I'd like to see more analysis before a final rule is issued.

Our communities are depending on this funding and there's just too much at stake to rush in.

Thank you.

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before
The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"A Review of the Federal Home Loan Bank System"
September 7, 2006

Good morning Mr. Chairman, Ranking Member Kanjorski, Member of the committee, and Chairman Rosenfeld.

Thank you for holding this hearing, Mr. Chairman.

The Finance Board's rule proposal to require FHL Banks to meet a fixed formula retained earnings requirement should be reconsidered because of its [potential adverse impact on the availability and cost of mortgage credit. As FHLBanks are forced to retain earnings, no matter what their individual business plans or risk profiles look like, over $2 billion will be retained and not distributed through FHLBank member institutions to the borrowing public. In addition, as FHLBank adjust their business operations to take into account that some of their large members may leave because FHLBank membership is no longer financially attractive, the cost of FHLBank advances to remaining members will increase and members will in turn pass on those increased costs to working class families seeking home mortgages. The Finance Board must consider these serious consequences before proceeding any further with its rule proposal.

If FHLBank members leave, another potential adverse effect of the rule proposal is that earnings of FHLBanks may decr5ease, thereby decreasing the amount of funds available for FHLBanks Housing Programs. Each year, FHLBanks contribute 10% of their earnings as seed capital to Affordable Housing Programs sponsored by local community groups and backed financially by FHLBank members. Since 1990, FHLBanks have provided over $2 billion in Affordable Housing Program funds. This public-private partnership is vital to providing decent housing opportunities for working class families, and the Finance Board must not inadvertently restrict the ability of FHLBanks to meet their Affordable Housing Responsibilities.

Another area of concern is the Finance Board's refusal to appoint public interest directors to the boards of directors of the FHLBanks. This self-imposed, two year old moratorium, in clear violation of the Federal Home Loan Bank Act requirement that the Finance Board appoint at least six directors to each FHLBank board, will cause a corporate governance crisis at FHLBanks by the end of this year, when virtually no appointed directors will remain. This is not some forgotten statutory provision--- the House passed GSE reform bill specifically retains this appointive system. The Finance Board should

meet its statutory responsibilities and fill all of the appointed director positions at the FHLBanks.

Mr. Chairman I ask unanimous consent to submit my statement to the record.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
SEPTEMBER 7, 2006

Chairman Baker and Ranking Member Kanjorski,

I want to express my sincere appreciation for you holding this hearing to review the status of the Federal Home Loan Banks and the activities of the Federal Housing Finance Board to date.

Originally begun in 1932, the Federal Home Loan Banks have undergone several changes, particularly since the cleanup of the savings and loan association failures of the 1980s. As a result, membership in the Banks has changed, today encompassing more commercial banks than savings associations and including credit unions, insurance companies, and some associated housing providers.

While the Banks' lending remains primarily housing-related, they now also include agricultural and small business lending, which are very important to my district in Texas. Thankfully, the changes have also resulted in special mission set-asides for low- and moderate-income housing, special programs for community development, and a continuing responsibility for paying off debt raised to fund deposit insurance payouts in the 1980s.

As we all know, the Federal Housing Finance Board (FHFB) regulates the System. The Board has broad statutory powers over the Banks. It uses these powers to ensure the safety and soundness of the Banks and to see that they carry out their public purpose of providing home finance. These powers enable the Finance Board to take preventive action to protect individual Banks.

To address the expanded size, scope and complexity of Federal Home Loan Banks, the Board has proposed requiring that all Federal Home Loan Banks increase their retained earnings. The stated goal of the proposal is to ensure that Federal Home Loan Banks have enough capital to redeem members' stock without creating a capital crunch or safety and soundness risk.

With the proposed rule in mind, I am concerned that the Finance Board may not have considered the impact the proposed capital regulation will have on the banks, thrifts, credit unions and others that depend on Federal Home Loan Banks for funding mortgages and to provide liquidity. I am also concerned about the impact the proposal might have on the Banks' ability to meet their three main missions.

Mr. Chairman, it is my hope that my concerns will be addressed during today's hearing.

Having said that, I yield back the remainder of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING TO REVIEW THE FEDERAL HOME LOAN BANK SYSTEM

THURSDAY, SEPTEMBER 7, 2006

Mr. Chairman, we meet this morning to once again examine the Federal Home Loan Bank System. As you already know, I share your deep interest in these important financial institutions. After all, we worked closely together for several years to include language to improve the system during our lengthy deliberations over H.R. 10, the landmark law to modernize the financial services industry.

Perhaps most importantly, our joint efforts in 1999 resulted in a much-needed update of the capital structure at each of the Federal Home Loan Banks. Until we acted on these matters, these financial institutions had operated under antiquated subscription capital rules created 67 years earlier in 1932.

Specifically, the law now requires each Federal Home Loan Bank to submit a plan to the Federal Housing Finance Board for approval that is "best suited for the condition and operation of the bank and the interests of [its] members." Since we completed our legislative work, all but one of the Federal Home Loan Banks have received approval from the Finance Board to put in place a revised capital structure.

A regulatory proposal put forward earlier this year by the Finance Board, however, now threatens to slow the progress being made to implement these statutorily required capital reforms. Specifically, this proposal would impose inflexible minimum retained earnings levels at each bank.

This proposal has generated an extensive policy debate. Ultimately, the Finance Board received 1,066 letters on its rulemaking plan. Less than one half of one percent of commenters, as I understand, supported the regulatory change.

Some of the key arguments raised against the plan include that it could result in a decision to engage in higher-risk activities and could undermine the housing mission of the system. Standard and Poor's has also observed that the proposal may "reduce the financial flexibility" of a bank to mange its capital positions and lessen the attractiveness of membership in the system.

While I share these apprehensions, I am most concerned about the failure of the Finance Board to conform this regulatory proposal to the specific capital statutory requirements outlined in H.R. 10. This plan would impose a uniform retained earnings requirement that every bank must adopt regardless of its preferences. While law mentions retained earnings as one source of capital, it does not mandate that a bank hold a specific minimum level. In fact, as I noted in my remarks on the conference report on H.R. 10, our goal was to create "a flexible capital structure."

In a recent letter sent to Chairman Oxley and Ranking Member Frank, today's witness suggests that the Finance Board's proposed capital revisions "satisfies the intent" of H.R. 10. As an author of these provisions, I must take exception to this conclusion.

Our intent in updating the capital standards used at each of the banks was not only to create a more permanent capital system, but also to provide maximum flexibility to each of the banks to develop their own capital structures to address their own special needs. Because the retained earnings proposal decreases such flexibility, it is inconsistent with the language of the law and legislative history.

In my floor statement on H.R. 10, I also noted that I had worked to ensure that we "would not place small financial institutions at a competitive disadvantage." This regulatory proposal, in my view, would undercut our hard work to achieve that important objective.

A study by the Stanford Washington Research Group found that the proposal would disproportionately affect smaller, publicly traded financial institutions. These entities would not only experience decreases in dividend income during the transition period, but unlike large financial institutions they would also be unable to tap into our capital markets via other financing mechanisms.

Beyond my strong reservations about this recent rulemaking proposal, I continue to be very concerned about the failure of the Finance Board to follow the clear statutory mandate regarding the appointment of public interest directors. Section 7 of the Federal Home Loan Bank Act indicates that at least six directors on each bank board "shall be appointed" by the regulator. As you know Mr. Chairman, I have a very strong interest in ensuring that the Federal Home Loan Banks benefit from an independent, public voice on their boards.

Inexplicably, at least 70 percent of the public interest director positions are currently vacant. If the Finance Board fails to act on these matters by the end of the year, there will be no public interest directors at any Federal Home Loan Bank and 40 percent of all board positions will be vacant.

These vacancies occur at a time when the system is addressing increasingly complex issues. They also create corporate governance problems in terms of the workload of the remaining elected directors, institutional memory of boards, and ensuring that Federal Home Loan Banks adhere to the system's missions to promote affordable housing and advance economic development.

In closing, Mr. Chairman, I have deep reservations about the retained earnings rulemaking as proposed by the Finance Board. I also have great apprehensions about the continued failure of the Finance Board to appoint public interest directors. I therefore hope that our witness today will forthrightly inform us about what he is doing to resolve these problems.

Rep. Ed Royce (CA-40)
Opening Statement
"A Review of the Federal Home Loan Bank System"
7 September 2006

Mr. Chairman, thank you for holding this hearing on "A Review of the Federal Home Loan Bank System." I would also like to thank Chairman Rosenfeld for his appearance and testimony today.

Over the past six years under Chairman Oxley's leadership, this Committee has held a number of important oversight hearings -- today's hearing is no exception. As one of the largest financial institutions in the United States and as one of the largest borrowers in the world, the Federal Home Loan Bank (FHLB) System plays a significant role in U.S. housing finance.

I have particular questions about some recent regulatory actions taken by the Federal Housing Finance Board (FHFB or Finance Board). More specifically, I am interested in learning more about the Finance Board's thinking and rationale behind **(1)** the recent subordinated debt offering at the Federal Home Loan Bank of Chicago, and **(2)** the proposed rule to increase retained earnings at the twelve banks.

FHLB Chicago Subordinated Debt Offering

I am concerned about recent Finance Board action that has allowed FHLB Chicago to use subordinated debt in determining compliance with its regulatory minimum capital requirement. It is my understanding that this waiver was granted so that the $1 billion subordinated debt offering could enable FHLB Chicago to redeem stock of withdrawing members, which has the effect of substituting equity capital with debt capital.

I am interested to know if this regulatory forbearance is not only unnecessary, but also is it inconsistent with the statutory minimum capital requirements this Committee passed in **Title VI** of Gramm-Leach-Bliley. Furthermore, I think this Committee and the public needs to learn more about how this subordinated debt offering could affect the joint and several obligations of the FHLB System as a whole.

Retained Earnings Proposed Rule
As to the retained earnings proposed rule, while I understand the intent behind the Finance Board's desire to increase the retained earnings at each of the twelve Banks, it is not evident how the Finance Board arrived at some of the proposed rule's specific requirements.

For example, the rule would require each Home Loan Bank to hold retained earnings of at least **one percent** of non-advance assets; however, it is not clear to me how or why the Finance Board arrived at the **one percent** figure. Perhaps the one percent number is a good target -- but I think it would be helpful for the Committee to have an understanding as to why the Finance Board believes each bank should be required to have that specific mix of regulatory capital.

Mr. Chairman, I would like to thank Chairman Rosenfeld for his willingness to engage the Committee today. I yield back.

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PREPARED TESTIMONY OF RONALD A. ROSENFELD
CHAIRMAN, FEDERAL HOUSING FINANCE BOARD
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

Thank you, Chairman Baker, Ranking Member Kanjorski, and distinguished members of the subcommittee. I appreciate the opportunity to present a statement to you about the Federal Housing Finance Board (Finance Board) and the Federal Home Loan Bank System (FHLBank System).

It has been more than a year since I appeared before this subcommittee, and a great deal has happened during that time. Today, I will update you on the performance and condition of the FHLBanks, highlight the actions the Finance Board has taken to enhance the safety and soundness of the System, and provide an overview of the actions we have undertaken to improve our oversight capabilities. I am confident that these steps benefit the public who are served by the housing finance and community development activities of the FHLBanks, as well as the FHLBanks and their shareholder/member institutions.

Before I address specifically the Finance Board and the FHLBank System, I would like to stress the need for reform of the supervision and regulation of the government-sponsored enterprises (GSE). The housing GSEs – Fannie Mae, Freddie Mac, and the 12 FHLBanks – are large complex entities. They are important to the nation's housing market and play a vital role in the financial markets. Thus, they should be overseen by a single strong independent regulator that has the full arsenal of supervisory and enforcement tools to ensure that they are operated in a safe and sound manner consistent with their mission.

Let me next share with you some observations. They are observations drawn from the first 18 months of my tenure as chairman of the Finance Board and they underpin the regulatory and supervisory operations of the Finance Board. The environment in which the FHLBanks operate has changed during the last five years. There has been further consolidation in

the financial services industry, increased use of derivatives to hedge mortgage activity, and changes in accounting, including adoption of new standards for accounting for derivatives. Those changes brought about increased risks and challenges to the business of the FHLBanks and contributed to increased earnings volatility. In some important instances, the FHLBanks did not respond quickly enough to keep pace with the changing environment. Many FHLBanks did not embrace and implement governance and risk management tools appropriate for the size and sophistication of their evolving business. The combination of inadequate skills and poor judgment created serious problems. An example is the initial rapid growth in the mortgage programs at some of the FHLBanks. The risks associated with and universally known to exist with portfolios of 30-year, fixed-rate mortgage loans were neither fully appreciated nor well-managed.

At the same time, the Finance Board had inadequate staff and technology. Just five years ago, the Finance Board had eight bank examiners and did not have the necessary risk models. Today, we have 30 safety and soundness examiners and mortgage specialists and seven Affordable Housing Program (AHP) and Community Investment examiners. The average experience of these examiners is over 15 years. In addition to the examiners and mortgage specialists, other personnel such as accountants, analysts, and economists, participate in at least a portion of the on-site examinations. Our technology has been upgraded, and we are now better able to model the FHLBanks' risks, particularly the interest-rate risk in mortgage portfolios.

The FHLBanks and the Federal Housing Finance Board have undergone significant changes and faced serious challenges in the last few years. We have each learned some important lessons. The FHLBanks learned lessons in governance and risk management. The Finance Board learned the benefits and need for early and resolute action when problems emerge.

Background

The Finance Board's primary duty is to ensure that the 12 FHLBanks and their joint office, the Office of Finance, operate in a financially safe and sound manner. In addition, the Finance Board ensures that the FHLBanks carry out their housing finance and community lending mission, remain adequately capitalized, and are able to raise funds in the capital markets.

The Federal Home Loan Bank Act requires the Finance Board to examine each FHLBank at least annually. Finally, the Finance Board is a non-appropriated agency that sets its own budget; it assesses the FHLBanks for the costs of its operation.

The 12 FHLBanks and the Office of Finance serve the public by promoting the availability of housing finance through more than 8,100 member institutions. The FHLBanks 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 FHLBanks are cooperatives; members own the stock of each FHLBank, and the members receive dividends on their investment. Insured banks, thrifts, credit unions, and insurance companies engaged in housing finance can apply for membership.

The FHLBanks play a unique role in housing finance. They make collateralized loans, called advances, to their members and eligible housing associates (principally state housing finance agencies). The advances are secured by mortgages and other eligible collateral pledged by members, housing associates, and their affiliates. 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 $587 million or less) for loans to small business, small farms, and small agribusiness. This flexibility allows these advances to support diverse housing markets, including those focused on low- and moderate-income households.

FHLBank advances can provide funding to smaller lenders that otherwise have limited access to funding sources. Smaller community lenders often lack access to funding alternatives available to larger financial entities, including repurchase agreements, commercial paper, and large deposits. FHLBank advances offer these lenders access to competitively priced wholesale funding.

Finance Board Operations

The Finance Board's fiscal year 2006 budget is $35,873,000, almost the same as the previous year's budget. I expect little change in the fiscal year 2007 budget from the 2006 budget. More than one-half of the Finance Board's budget in fiscal year 2006, $18,745,000, is budgeted for our Office

of Supervision, which is responsible for on-site safety and soundness and AHP examinations, off-site monitoring of the 12 FHLBanks, and examination and monitoring of the Office of Finance. In addition, much of the remainder of the budget, including our information technology and legal budgets, goes to agency activities that directly or indirectly support our supervisory programs. The Finance Board is a careful steward of the funds we assess the FHLBanks. As the above figures show, our expenditures are for activities that support the Finance Board's primary statutory duty—ensuring the safety and soundness of the FHLBanks.

Two overarching principles guide the supervisory activities of the Finance Board – one is the regulatory independence of the agency and the other is the Finance Board's expectation that the FHLBanks operate consistent with high standards of governance and risk management. By regulatory independence I mean that the Finance Board is an arms-length regulator. While we have interests in common with the System – the desire for strong earnings, strong capital, fulfillment of mission, and others – our responsibilities are nonetheless those of a safety and soundness and mission regulator.

With regard to the second principle, we expect the directors and management of the FHLBanks to adhere to the highest standards of ethics, corporate governance, accounting, and risk management. As GSEs, the FHLBanks enjoy a special privilege in the capital markets. Consistent with that privilege, we also expect the Banks, as government-sponsored enterprises, to maintain low risk profiles. The joint and several liability that the FHLBanks have for the System's consolidated obligations also underscores the need for each individual FHLBank to operate with high standards.

In March 2005, when I last appeared before this committee, I reported on four supervisory initiatives, each of which is consistent with those overarching principles. Those initiatives remain pertinent to our supervisory and regulatory efforts. First, in late 2005, we began a program to collect information from the FHLBanks to measure and monitor the interest-rate risk in their mortgage portfolios. We spend more resources on risk measurement, monitoring, and assessment than any other single supervisory area. For example, we measure the effects of various interest rate changes and pass that information to our supervisory staff. With this information, examiners and economists are able to have more informed

discussions with the FHLBanks and their boards of directors about risk exposures, risk measurement and modeling, and the implications of possible interest rate movements on earnings, capital, and dividends.

Second, in 2005 we instituted a quarterly visitation program. The program calls for the examiner-in-charge of each FHLBank, along with one or two staff members, to visit the FHLBank once a quarter between annual examinations. We have found these visits to be an effective way to follow-up on examination issues and other developments, including changes to business strategies and risk exposures. We are continuing to refine the visitation program. In situations where there are no significant supervisory concerns, the quarterly visitations will be extended to semi-annual visitations to lessen burden and conserve Finance Board resources for supervision of higher risk activities. In other cases, the visitation may be semi-annual, but expanded to include a targeted examination with a team of examiners and other staff participating.

Third, we continue to emphasize corporate governance and risk management, two critical elements of sound banking practice. To further better governance at the FHLBanks, in 2006 we amended our regulations regarding director eligibility. Those amendments permit the FHLBanks to be more involved in identifying stewardship needs and in assuring that elected directors meet those needs. In addition, we intend to include an explicit assessment of corporate governance in the examination rating system that we plan to implement in 2007.

And fourth, I committed that we would provide additional guidance regarding the Affordable Housing Program. The AHP was created when Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. From inception through 2006, FHLBank contributions to the AHP total $2.5 billion and the funds used to develop, rehabilitate, or finance more than 519,000 housing units. In December 2005 the Finance Board had issued for comment a revised Affordable Housing Program regulation that will streamline and reorganize the regulation. The comments were generally positive, but did raise some issues that Finance Board staff is working on before finalizing the rule. That rule is scheduled to be considered by our board of directors later this month.

In addition to these initiatives, the Finance Board continues to enhance its supervisory capabilities. The number of supervisory staff has

increased, enhancements were made to our examination guidance and supervisory program, and we continue to look for other ways to ensure our supervisory efforts are relevant and risk-focused. For example, later this month our Office of Supervision will be seeking comments on a rating system for the FHLBanks. The new rating system will further enhance our communication with the FHLBanks, make our examination process more transparent, and enable us to better focus our examination and supervision on those FHLBanks and on those areas within FHLBanks that are of greatest supervisory concern.

Condition and Performance of the Banks

At June 30, 2006, the combined assets of the 12 FHLBanks were $1.024 trillion, up from $1.003 trillion at the end of 2005. If the FHLBanks were a bank holding company, they would be the fourth largest bank holding company in the country, smaller only than Citigroup, JP Morgan Chase, and Bank of America.

Loans to members, or advances, are the largest asset class constituting 62 percent of assets. (See Chart 1.) Advances of $638 billion are 0.5 percent higher now than at the end of 2005. Mortgage loans purchased from members are $102 billion or 10 percent of assets. After reaching a peak of almost $116 billion in June 2004, mortgage loans have been trending downward. This downtrend reflects general mortgage market conditions that are unfavorable toward the acquisition and holding of fixed-rate conforming mortgages as well as strategic decisions by several FHLBanks to de-emphasize the holding of mortgage loans.

Advances concentrations reflect the concentration of assets in the financial services industry. The top 10 holders of advances account for 33 percent of the System total of advances. (See Charts 2 and 3.) Mortgage purchases are more heavily concentrated than advances. Almost 70 percent of mortgages in the FHLBank System were purchased from 10 members. (See Chart 4.) As of year-end 2005, three FHLBanks, Des Moines, Pittsburgh, and Seattle, had portfolios with more than 80 percent of their mortgages from a single member. (See Chart 5.)

The FHLBanks hold investment portfolios totaling $230 billion or 23 percent of assets. At June 30, 2006, these investment portfolios are primarily mortgage-backed securities ($128 billion), prime short-term

money-market instruments ($83 billion), and federal agency securities ($19 billion).

The FHLBanks principally fund their operations by issuing consolidated debt obligations for which each FHLBank is jointly and severally liable. The consolidated debt obligations are issued by the Office of Finance. Outstanding consolidated obligations are $939 billion.

The total capital of the FHLBanks is $45.5 billion or 4.44 percent of assets. Total capital comprises all stock issued by the FHLBanks plus retained earnings. Of that total, retained earnings are $3.0 billion or 0.30 percent of assets.

In the first six months of 2006 the FHLBanks' net income was $1.258 billion compared with $900 million for the comparable period of 2005. The return on assets was 0.25 percent compared with 0.19 percent in the first half of 2005. The improvement in reported profitability is attributable to the rise in interest rates in 2006 that has increased the FHLBanks' returns on invested capital.

Regulatory Actions

The Finance Board has undertaken three important regulatory initiatives over the course of the last several years. One is the proposed revision and update of the AHP regulation that was described previously. The other two initiatives are the rule requiring SEC registration by the FHLBanks and a proposed rule on retained earnings and excess stock.

SEC Registration Final Regulation

The FHLBanks are large financial institutions. They range in size from $40 billion to over $200 billion. There was no legitimate reason that institutions of that size, sophistication, and importance should not be SEC registrants. As of August 8, 2006, all 12 FHLBanks are now SEC registrants, a process that took nearly two years. Looking back, the rule requiring SEC registration, the process undertaken by the FHLBanks to meet regulation requirements, and the outcomes are all positive. The process undertaken by the FHLBanks to meet the rule's requirements entailed an accounting review by the world's accounting expert, the SEC. The review identified incorrect accounting treatment at some of the FHLBanks, most

typically related to their hedging activities. As a result, half of the FHLBanks either have or will restate prior period financial statements. In addition to identifying improper accounting in some instances, the process surfaced inadequacies in the FHLBanks' financial accounting systems and personnel.

The outcomes, particularly greater transparency in the FHLBanks' financial reports, are similarly beneficial. Investors and others now have a full and fair view of the financial condition and performance of each of the FHLBanks; a view by which each FHLBank can now be more easily compared to each other. Each of the FHLBanks is able to better understand the operations and condition of the other FHLBanks; something that is critical in light of the joint and several liability each has for the debt issued on behalf of the other FHLBanks.

As a consequence of the registration process and the resulting restatements, the combined financial statements for the System for 2004 and 2005, prepared and published by the Office of Finance, have been delayed. Finance Board staff is in discussion with the Office of Finance regarding the timing of publication of those statements. The timing will depend in large part on resolution of remaining questions the SEC has regarding the hedge accounting at one FHLBank. I expect, however, that the 2005 and 2004 annual financial statements will be available before this year-end.

In anticipation of the release of financial statements for each FHLBank, the Finance Board, in July, issued an Advisory Bulletin to the FHLBanks removing any regulatory impediments for disclosing "unpublished information" to the extent it would need to be disclosed for an FHLBank to meet its obligations under the securities laws. The most important "unpublished information" covered by that bulletin is the factual content in examination reports. While we did not authorize the release of examination reports, we authorized the FHLBanks to disclose information that would be necessary for a user of its financial statements to understand any material effects the supervisory process might have on an FHLBank's future operations or its financial condition and performance.

Retained Earnings and Excess Stock Proposed Regulation

In April 2006, the Finance Board issued for public comment a proposed rule to strengthen the capital composition of the FHLBanks. The

proposed capital rule on retained earnings and excess stock was issued for a 120-day comment period, which closed on July 13, 2006. We are in the process of reviewing and analyzing the 1,066 comments that we received on the proposal. I assure you that we are taking an open-minded and cautious approach to the rulemaking. Any steps that we take will conform fully to the capital provisions of the Gramm-Leach-Bliley Act of 1999 (GLB), and we will carefully consider the comments we have received through the rulemaking process.

Retained earnings are a critically important component of capital for the FHLBanks. Increased holdings of mortgage assets, with long contractual lives and borrower prepayment options, coupled with adoption of Statement of Financial Accounting Standards 133, have contributed to higher market risk exposure and greater earnings fluctuations among the FHLBanks. In light of the statutory mandate that FHLBank stock trade at par, retained earnings must be sufficient to absorb losses in reported income if impairment to the par value of members' capital stock is to be avoided. The case for adequate levels of retained earnings is straightforward and compelling. If losses exceed retained earnings in any FHLBank, (i) accountants could compel FHLBank members to write down the value of their FHLBank stock, (ii) regulators could increase the capital charge against FHLBank stock, and (iii) members could limit new borrowing from the FHLBank to avoid having to acquire additional FHLBank stock that could have to be written down to reflect impairment.

The proposed regulation is only the most recent in a series of steps the Finance Board has taken in the past three years to strengthen the capital management of the FHLBanks. On August 18, 2003, the Finance Board's Office of Supervision issued an Advisory Bulletin requiring each of the FHLBanks to adopt a capital management and retained earnings policy, which should include, at least annually, an assessment of the adequacy of its retained earnings in light of alternative possible future financial and economic scenarios. Since that time, capital management and retained earnings have been one focus of our annual examinations, and the FHLBanks have made progress in increasing their retained earnings. The progress, however, has been modest and uneven among the FHLBanks, and inadequate at some.

Excess stock, also referred to as "voluntary stock," is not excess capital for the FHLBank. Rather, it is capital stock that a member holds in

excess of the amount of membership stock and/or activity stock that it is required to purchase as a condition of membership or to support activities with the FHLBank.

Excess stock presents three principal issues for the Finance Board. First, member institutions that hold excess stock as an "investment" can redeem excess stock at par value without curtailing their activities with the FHLBank or withdrawing from membership. This "investment" purpose makes excess stock a less dependable source of capitalization than required membership or activity stock. Second, excess stock is typically used to capitalize non-advance assets, such as mortgages, mortgage-backed securities, and other investments. Using shorter-term, redeemable capital to capitalize mortgages or other long-term assets is also undesirable from a safety and soundness perspective to the extent that redeemable capital is supporting long-term assets. Third, using excess stock to capitalize investment securities beyond an amount needed for primary liquidity is undesirable from a public-policy perspective to the extent that the government-sponsored enterprise borrowing privilege is being used to "arbitrage" the GSE advantage to fund activities that are not related to the FHLBanks' core mission.

In light of those concerns, the proposed rule establishes a minimum required level of retained earnings, limits dividends if an FHLBank is below its retained earnings requirement, and restricts an FHLBank's reliance on excess stock. Recognizing the significance of the proposed rule, we provided for a 120-day comment period, which is substantially longer than normal.

We received over 1,000 comments, most calling for modification of the proposal and some calling for us to withdraw the proposal. I would say the following, and I should preface my remarks by saying that I am speaking for myself, not my colleagues or the board of directors as a body. There has been nothing in the debate to this point in time that would compel me to favor withdrawing the proposal. So long as there is a statutory provision that the capital stock is to be bought and sold at par value, retained earnings is the "operating capital" of the FHLBanks. It is critically important that retained earnings be sufficient to protect the par value of the capital stock from impairment. With respect to the proposal regarding excess stock and stock dividends, we have some rather sobering experiences that demonstrate that excess stock can create instability in an FHLBank's capital. We also

have seen FHLBanks engage in either "non-mission" activities or otherwise more risky activities to generate returns on excess capital.

The comments did raise issues that deserve consideration. The primary issues are: the limitation on dividends until an FHLBank reaches the minimum retained earnings level; the prohibition on stock dividends; and the fact that the rule treats all non-advance assets the same, regardless of risk or tenor.

The proposed rule imposes a limitation on dividends of 50 percent of income until an FHLBank reaches its retained earnings requirement, unless the Finance Board approves otherwise. The 50 percent limit was proposed under the presumption that it would be inappropriate for an FHLBank's dividend payout to exceed its income retention until it has reached its minimum level of retained earnings. Many commenters questioned the 50 percent dividend payout limit, absent an immediate safety and soundness issue. That is a constructive observation, and we should consider a higher dividend payout ratio which would extend the time for the FHLBanks to reach the retained earnings minimum.

With respect to the prohibition on stock dividends, the issue is really one of excess stock. Those commenting suggested that if the Finance Board will accept some level of excess stock, which the proposed regulation does allow, we should not determine how a member accumulates that excess stock. It is a reasonable inquiry that we can pursue.

Finally, it was also widely-suggested that assets be risk-weighted for purposes of determining the required minimum level of retained earnings, instead of a flat one percent requirement for non-advance assets. For example, our proposal treats mortgage loans the same as cash and Treasury securities. It also treats short-term assets the same as long-term assets. We should consider whether adjusting the level of retained earnings held for different categories of assets with different risk characteristics is appropriate. Should we take that approach, I expect it would be a simple risk-based capital framework.

While the timing of a final capital regulation is uncertain, our actions will take into account the consequences of any rulemaking on the FHLBanks and their members. We will be guided by three principles as we proceed to a final rule:

- Our regulation should not impede good business judgment about the composition of an FHLBank's balance sheet.

- Our regulation should not materially alter the value of membership in an FHLBank. For example, the time allowed each FHLBank to reach its required level of retained earnings must reflect the need for each FHLBank to offer value to its members, including the members' expectations of a reasonable dividend yield on their investments in the FHLBank.

- Our regulation should recognize that where an FHLBank has engaged in prior conduct that was permissible under the then-existing rules, any change in those rules should afford the FHLBank a reasonable time to adjust its business strategies.

Any requirements affecting the capital composition of the FHLBanks or restrictions on the level or form of FHLBank dividends will balance our regulatory and supervisory interests with the need for the FHLBanks to offer value to their members.

Supervisory Agreements

The Seattle and Chicago Banks continue to operate under Written Agreements with the Finance Board. While the particulars of each case are different, in both instances the Banks took actions and engaged in business activities that were imprudent. Both had a high level of excess stock and both were intent on growing their mortgage portfolios.

The Seattle Bank was operating with too much excess stock and too little retained earnings. To generate returns on the excess stock, the Seattle Bank imprudently grew its mortgage portfolio and took interest-rate risk in its investment portfolio. When the problems were identified, the Seattle Bank had insufficient retained earnings to deal comprehensively with them, thus a supervisory action was necessary. That action prohibits the payment of dividends, thereby increasing retained earnings, and prohibits the repurchase of members' stock. The problems at the Seattle Bank are now under control, although the situation is a long-term workout.

The Chicago Bank grew its mortgage portfolio by relying on excess stock. The mortgage portfolio increased to 60 percent of assets and was supported by a commensurate amount of member excess stock. Thus, it was supporting long-term assets with stock that had a six-month call by the members. Safety and soundness issues related to its high level of excess stock intensified when its earnings declined and it lowered dividends in a rising interest-rate environment. As a consequence of the reduced dividend payout, virtually all shareholders wanted their excess stock repurchased to take advantage of higher returns on alternative investments.

In the case of the Chicago Bank we needed to act immediately. There was a loss of confidence by the member/shareholders as evidenced in 2005 by members seeking repurchase of hundreds of millions of dollars in excess or voluntary capital stock. In deliberating various solutions, we established and strictly adhered to several principles. Specifically, the solution:

- Must be complete and offer a way forward. We would not entertain a "fix," *i.e.*, an option that served only put off until another day, and to someone else's watch, a crisis;

- Must provide the Bank sufficient time and flexibility to deal with its embedded financial problems;

- Must not erode the protection of holders of consolidated obligations;

- Must place any costs that might be realized first at the doorstep of the Bank's member/shareholders; and

- Must be limited in reach, *i.e.*, it should not be one that sets precedent or opens the door to "creative" funding or capital activities for other Banks.

Against those five principles, we explored various options. In addition to permitting the Bank to issue subordinated debt, the options were: permitting the Bank to issue consolidated debt to redeem voluntary stock; requiring the Chicago Bank to shrink its assets; combining the Chicago Bank with another FHLBank; prohibiting redemptions of any stock; prohibiting stock redemptions except in the case of members who were withdrawing

from the Chicago Bank; and allowing the other FHLBanks to buy the debt of the Chicago Bank. Each of the options was carefully explored and analyzed. As we worked through all the options, it became clear to us that, especially given the time available, the only one that met each of the five aforementioned principles was the subordinated debt option.

We authorized the Chicago Bank to issue 10-year subordinated debt with a fixed rate of 5.625 percent. The debt, under certain conditions and with certain limitations, can be used by the FHLBank to satisfy a portion of its regulatory leverage requirements. The principal limitation is that until the Chicago Bank converts to a new capital plan under the Gramm-Leach-Bliley Act, the amount of subordinated debt that can be used to satisfy the Bank's leverage requirement is phased-out over the last five years of the instrument.

Part of our analysis was a legal review of the transaction. While GLB limits the types of instruments that an FHLBank can use to satisfy the statutory capital requirements, the Chicago Bank has not yet converted to a post-GLB capital plan, and thus is not subject to the capital provisions of the GLB Act. Consequently, subordinated debt can be used to satisfy the regulatory leverage requirement of the Chicago Bank; it cannot be used for this purpose at any other FHLBank. Therefore, the approval of the issuance of subordinated debt will be limited to this one case only.

Now, some 90 days after the transaction, I can say with confidence that the "subordinated debt solution" was the right one. We kept to the principles we established. We provided the Chicago Bank and its new management team time to work through and resolve financial issues, and we replaced $1 billion in shorter-term, redeemable capital, *i.e.*, excess stock, with 10-year subordinated debt.

Conclusion

At the Finance Board, the focus of our supervisory program has shifted over the past five years. It has moved from one in which our examinations were more oriented to compliance with Finance Board rules and the FHLBanks' internal policies to one that emphasizes strong governance, risk management and controls, and the effective implementation

and administration of the Affordable Housing Program. Our supervisory program and regulatory approach now better addresses the risks inherent in the activities conducted by the FHLBanks today and into the future. I am pleased with the progress that has been accomplished, and I am optimistic about the improvements that are underway.

The FHLBank System is financially safe and sound. While there are particular supervisory problems, they are under control. Moving forward, our regulatory focus will be on realizing the enhancements to the FHLBanks' capital structure envisioned by the Gramm-Leach-Bliley Act of 1999. Our supervisory focus will be to continue to be preemptive so supervisory issues do not become safety and soundness problems.

Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, thank you for the opportunity to report on the condition of the FHLBank System and the Federal Housing Finance Board.

Chart 1

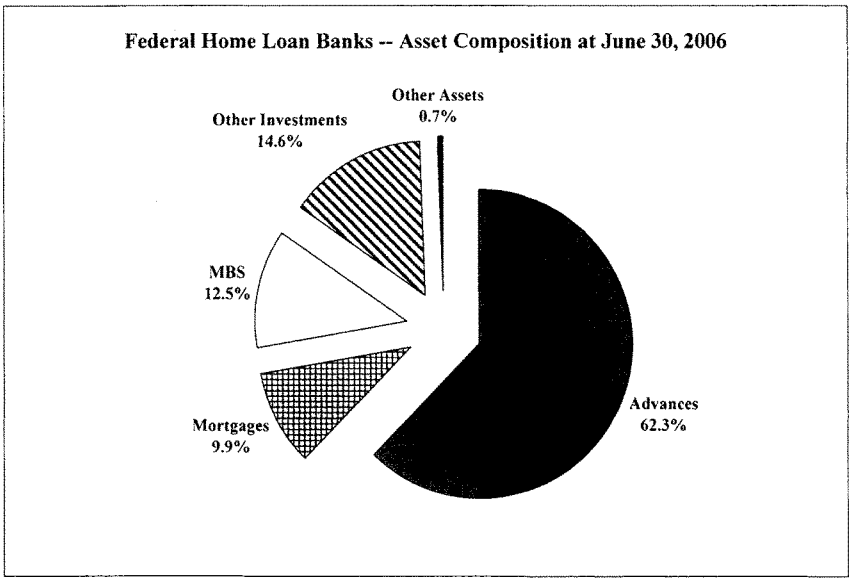

Federal Home Loan Banks -- Asset Composition at June 30, 2006
Other Assets
0.7%
Other Investments
14.6%
MBS
12.5%
Mortgages
9.9%
Advances
62.3%

Chart 2

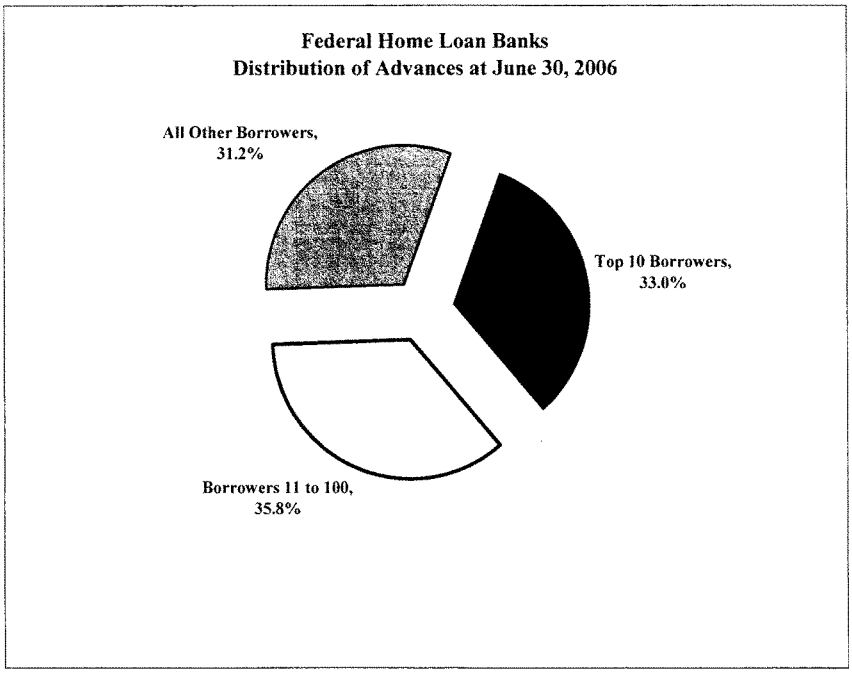

Federal Home Loan Banks
Distribution of Advances at June 30, 2006
All Other Borrowers, 31.2%
Top 10 Borrowers, 33.0%
Borrowers 11 to 100, 35.8%

Chart 3

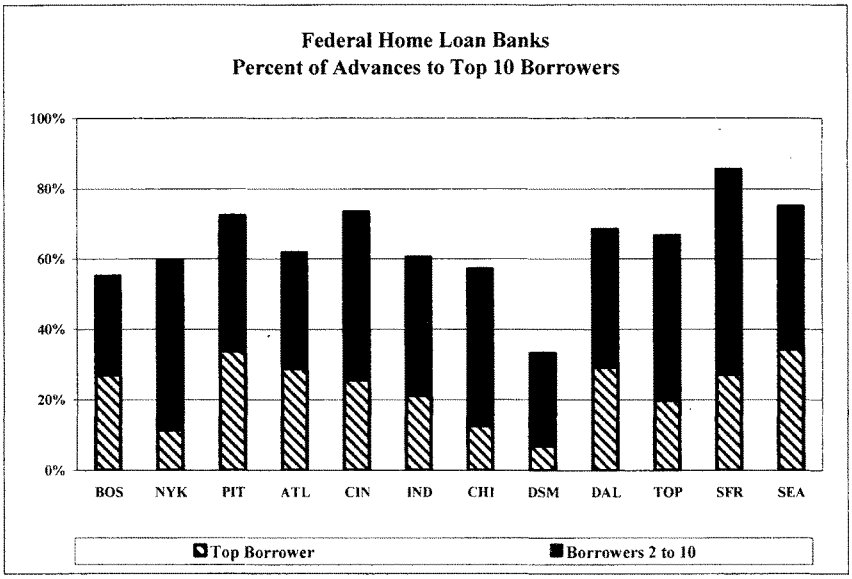

Federal Home Loan Banks
Percent of Advances to Top 10 Borrowers
100%
80%
60%
40%
20%
0%
BOS
NYK
PIT
ATL
CIN
IND
CHI
DSM
DAL
TOP
SFR
SEA
Top Borrower
Borrowers 2 to 10

Chart 4

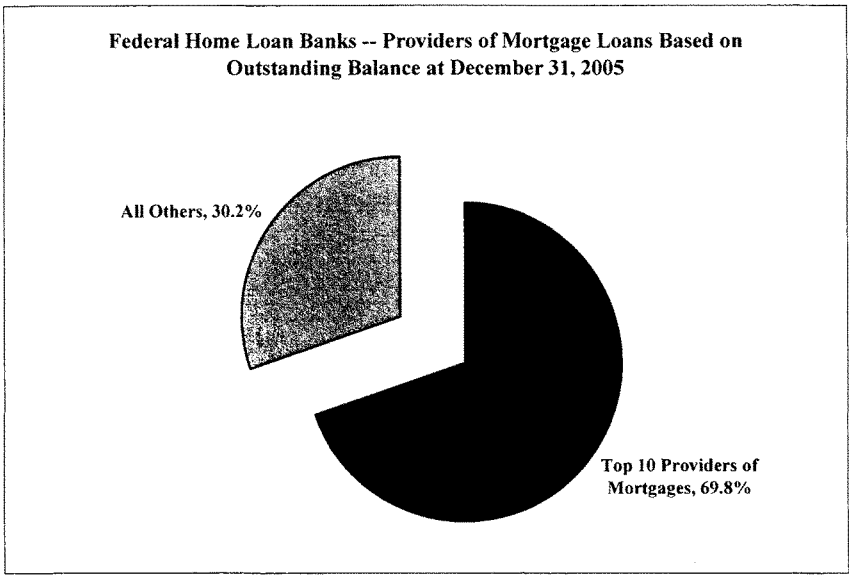
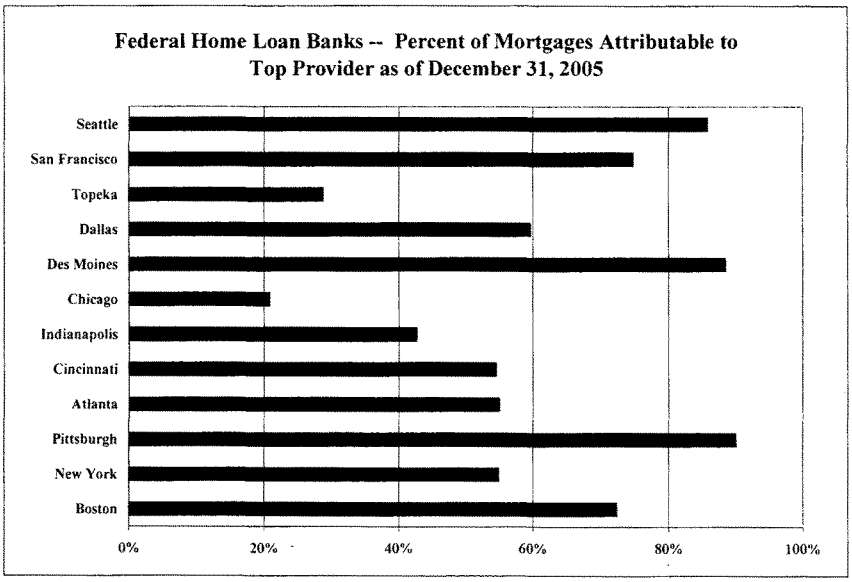

Federal Home Loan Banks -- Providers of Mortgage Loans Based on Outstanding Balance at December 31, 2005
All Others, 30.2%
Top 10 Providers of Mortgages, 69.8%

Chart 5


Federal Home Loan Banks -- Percent of Mortgages Attributable to Top Provider as of December 31, 2005
Seattle
San Francisco
Topeka
Dallas
Des Moines
Chicago
Indianapolis
Cincinnati
Atlanta
Pittsburgh
New York
Boston
0%
20%
40%
60%
80%
100%

July 11, 2006

Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006

Re: Federal Housing Finance Board Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks
RIN Number 3069-AB30
Docket Number 2006-03

Attn: Public Comments

We write respectfully to express our concern with the proposed capital rule referenced above and the deleterious effect it could have on affordable housing. Our concerns regarding the proposed capital rule stem from the very real potential that the rule will reduce the profitability of the Federal Home Loan Bank System as a whole and thereby reduce the overall contributions to the Affordable Housing Program (AHP). The proposed rule would require each Federal Home Loan Bank (FHLBank) to meet a fixed formula minimum retained earnings standard of $50 million plus one percent of non-advance assets. Over three years, FHLBanks would have to add over $2 billion to their retained earnings as a result of this proposal. Estimates of the impact of this requirement include required increases of $500 million for the FHLBank of San Francisco, $280 million for the FHLBank of Seattle, $180 million for the FHLBank of Cincinnati and $150 million for the FHLBank of Pittsburgh. We are very concerned that the required increases to the retained earnings of the FHLBanks will lead to significant reductions in AHP contributions.

The proposed limitation on dividend payments could have the consequence of driving large members from the FHLBank System. Many large members can access the capital markets themselves and as the "all-in" cost of FHLBank advances increases due to dividend limitation, these members could decrease their usage of FHLBank advances or even leave the System. This could result in the shrinking of FHLBank assets and earnings.

As you know, 10 percent of FHLBank profits are dedicated to the AHP. In 2005, a total of $280 million in AHP funds were awarded, funding hundreds of affordable housing units. If there is a decline in the number of large members, and thus profits, the Affordable Housing Program will be significantly curtailed.

Additionally, a decrease in volume of the FHLBank System will result in a higher cost of advances. Smaller members have no other access to the long-term debt markets. Raising the cost of FHLBank credit to small financial institutions will directly affect the amount of affordable housing lending these members can do. It could also raise borrowing costs for working families who are struggling to find mortgage funding. In light of the recent consumer price index information release, there does not appear to be an end in sight to interest rate increases. Higher borrowing costs, combined with an interest rate increase, could serve to end the dream of homeownership for many Americans.

In light of these possible impacts, we respectfully request that the Federal Housing Finance Board withdraw the proposed rule and issue an Advanced Notice of Proposed Rulemaking in order to

better study the potential effects of such changes on the supply of affordable housing in our nation. Thank you for your consideration.

Sincerely,

Alexandria (LA) Affordable Housing Corporation

American Association of Homes and Services for the Aging

California Housing Partnership

CityView America

Community HousingWorks, San Diego

Corporation for Supportive Housing

Enterprise Community Partners

Habitat for Humanity International

Housing Assistance Council

Institute for Housing Management Innovations

National American Indian Housing Council

National Association of Local Housing Finance Agencies

National Community Reinvestment Coalition

National Housing Conference

National Housing & Rehabilitation Association

National Housing Trust

National Low Income Housing Coalition

National NeighborWorks Association

New York Housing Conference

San Diego Housing Federation

Tacoma Pierce County Affordable Housing Consortium

Tarragon Corporation

The John Stewart Company

STANDARD &POOR'S RATINGSDIRECT

RESEARCH

FHFB Proposed Retained Earnings Regulation Poses Challenges For FHLBs

Publication date: 13-Jul-2006
Primary Credit Analyst: Victoria Wagner, New York (1) 212-438-7406; victoria_wagner@standardandpoors.com
Secondary Credit Analysts: Anne Cosgrove, New York (1) 212-438-7690; anne_cosgrove@standardandpoors.com
Robert B Hoban, Jr., New York (1) 212-438-7385; robert_hoban@standardandpoors.com
Scott Sprinzen, New York (1) 212-438-7812; scott_sprinzen@standardandpoors.com

The New Regulation Poses Inherent Conflicts With The Core Business Of A FHLB

The critical core mission of a FHLB is providing liquidity through the advancement of funds to its members with the goal of enhancing the availability of credit for home finance. The core business of the FHLBs, advances (collateralized loans), has been a steady, low-risk business for all of the banks as in the history of the system none of the banks has ever taken a credit loss on an advance. As a result, the FHLBs are active in the money markets, many times daily, raising liquidity on a regular basis to manage and anticipate member liquidity needs. At times the FHLBs collectively are the largest seller of fed funds in the market. Because of this liquidity role, the FHLBs' business is subject to the cyclical business of its member financial institutions.

Member bank advance activity is dictated by the cyclical business patterns of deposit flows and loan portfolio growth. Demand for Advances typically rises in challenging deposit markets and when mortgage portfolio growth is at peak levels.

Advance demand for some of the banks has increased during the past year, with the growth of adjustable-rate mortgage assets at member banks fueling their demand for low-cost funding. Also, for the larger member institutions, their national capacity to originate mortgage loans outstrips their regional–based deposit franchises' capacity to raise low-cost core deposits. Other examples of this cyclical business dynamic of member banks was evidenced in the historic mortgage refinance market of 2002-2004 when the most active MPP and MPF FHLBs saw record delivery and growth of qualifying mortgage loans from its approved members.

Critical to best execution of its core mission of providing liquidity is the capacity for a FHLB to maintain strong liquidity on its own balance sheet. The strong liquidity profiles of the FHLBs' credit profile has been a critical rating factor supporting the 'AAA' and 'AA' counterparty credit ratings Standard & Poor's has on the banks. As currently written in the proposed regulation, the nondifferentiation of retained earnings requirement for all nonadvance assets, without regard to their inherent risks (money market assets versus MBS), could reduce the liquidity profile of the FHLBs.

Key Rating Issues

The GLB Act significantly transformed and strengthened the capital structure of the individual FHLBs, with specific minimum regulatory capital requirements and the adoption of a new capital plan that was approved by the bank's board of directors and the FHFB. The capital plans for the banks included the member stock purchase requirements as a condition not only for membership but also business activity-based requirements for member banks. Standard & Poor's viewed the new capital structure as an improvement to the credit profile of the FHLBs. Also, the August 2003 Advisory Bulletin requiring the FHLBs to submit their assessment of required retained earnings in light of the critical market, credit, and operational risk exposures of the bank and tie it to the business profile of the bank was viewed positively from a ratings perspective. This regulatory advisory addressed a key rating issue for some of the banks that failed to build an appropriate level of retained earnings to support their higher risk profiles.

The new proposed capital regulation does not appear to significantly enhance or improve the current regulatory capital framework now in place for the FHLBs under the GLB Act of 1999 and the August 2003 Retained Earnings Advisory Bulletin. The introduction of this potential regulation at a minimum raises a concern regarding the status of the current capital plans now in place at all but one of the FHLBs, the potential to reduce the financial flexibility of a FHLB in managing its capital position, and reducing the attractiveness of membership to a FHLB by inhibiting the bank's ability to execute prudent capital management practices within the confines of a cooperative ownership structure. Also, many of the key issues the FHFB wants to address in the system-excess stock investing, increasing the level of retained earnings, and the payment of dividends-can be done within the capital plan requirements under the GLB Act and their regulatory authority to exercise supervisory powers in the approval of capital plans and retained earnings policy. Should this proposed regulation be adopted as it is currently written, Standard & Poor's will have to monitor any negative impacts to the liquidity profile of the individual banks, core business growth dynamics, and membership trends.