AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

LEGISLATIVE PROPOSALS ON GSE REFORM

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 TENTH CONGRESS

FIRST SESSION

MARCH 12, 2007

Printed for the use of the Committee on Financial Services

Serial No. 110–12

U.S. GOVERNMENT PRINTING OFFICE

35–404 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
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin,
LINCOLN DAVIS, Tennessee
ALBIO SIRES, New Jersey
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
TIM MAHONEY, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
CHRISTOPHER S. MURPHY, Connecticut
JOE DONNELLY, Indiana
ROBERT WEXLER, Florida
JIM MARSHALL, Georgia
DAN BOREN, Oklahoma

SPENCER BACHUS, Alabama
RICHARD H. BAKER, Louisiana
DEBORAH PRYCE, Ohio
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
STEVEN C. LaTOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, Jr., North Carolina
JUDY BIGGERT, Illinois
CHRISTOPHER SHAYS, Connecticut
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
RICK RENZI, Arizona
JIM GERLACH, Pennsylvania
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
GEOFF DAVIS, Kentucky
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MARSHA BLACKBURN, Tennessee
MICHELE BACHMANN, Minnesota
PETER J. ROSKAM, Illinois

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

PAUL E. KANJORSKI, Pennsylvania, *Chairman*

GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
NYDIA M. VELÁZQUEZ, New York
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin,
LINCOLN DAVIS, Tennessee
ALBIO SIRES, New Jersey
PAUL W. HODES, New Hampshire
RON KLEIN, Florida
TIM MAHONEY, Florida
ED PERLMUTTER, Colorado
CHRISTOPHER S. MURPHY, Connecticut
JOE DONNELLY, Indiana
ROBERT WEXLER, Florida
JIM MARSHALL, Georgia
DAN BOREN, Oklahoma

DEBORAH PRYCE, Ohio
RICK RENZI, Arizona
RICHARD H. BAKER, Louisiana
CHRISTOPHER SHAYS, Connecticut
PAUL E. GILLMOR, Ohio
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
EDWARD R. ROYCE, California
SHELLEY MOORE CAPITO, West Virginia
ADAM PUTNAM, Florida
J. GRESHAM BARRETT, South Carolina
BLACKBURN, MARSHA, Tennessee
GINNY BROWN-WAITE, Florida
TOM FEENEY, Florida
SCOTT GARRETT, New Jersey
JIM GERLACH, Pennsylvania
JEB HENSARLING, Texas
GEOFF DAVIS, Kentucky
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
PETER J. ROSKAM, Illinois

CONTENTS

	Page
Hearing held on:	
March 12, 2007	1
Appendix:	
March 12, 2007	43

WITNESSES

MONDAY, MARCH 12, 2007

Connelly, Arthur R., Chairman & CEO, South Shore Savings Bank, on behalf of America's Community Bankers	10
Menzies, Michael, President/Chief Executive Officer, Easton Bank and Trust Company, on behalf of the Independent Community Bankers of America	11
Petrou, Karen Shaw, Managing Partner, Federal Financial Analysts, Inc.	13
Price, John R., President and Chief Executive Officer, Federal Home Loan Bank of Pittsburgh, on behalf of The Council of Federal Home Loan Banks	4
Robbins, John M., CMB, Chairman, Mortgage Bankers Association	9
Stern, Scott, Chief Executive Officer, Lenders One, Chairman, National Alliance of Independent Mortgage Bankers	15
Stevens, Thomas M., 2007 Immediate Past President, National Association of Realtors	7

APPENDIX

Prepared statements:	
Bachus, Hon. Spencer	44
Kanjorski, Hon. Paul E.	46
Connelly, Arthur R.	48
Menzies, Michael	57
Petrou, Karen Shaw	69
Price, John R.	76
Robbins, John M.	93
Stevens, Thomas M.	115

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Kanjorksi, Hon. Paul E.:	
Statement of the American Bankers Association	125
Statement of the Asian Real Estate Association of America	131
Statement of the National Association of Federal Credit Unions	134
Statement of the National League of Cities	137
Statement of the Pennsylvania Bankers Association	139

LEGISLATIVE PROPOSALS ON GSE REFORM

Monday, March 12, 2007

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 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Present: Representatives Kanjorski, Moore of Kansas, Lynch, Klein, Perlmutter, Murphy, Donnelly; Renzi, Baker, and Garrett.

Also present: Representative Maloney.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

We have opening statements, and I will take the opportunity to put my opening statement in the record. We will have two, and then if there are any additional statements, we will have them.

We meet this afternoon to examine, once again, how best to regulate the housing government-sponsored enterprises, or GSEs. The debate on GSEs regulatory reform began 7 years ago this month, in 2000, when we held a hearing on H.R. 3703, the Housing Finance Regulatory Improvement Act. In every session of Congress since then, the House has had at least one regulatory reform bill under consideration. The Financial Services Committee has also held dozens of hearings on these matters over the years, and we have heard from scores of witnesses.

These hearings, as well as external events, like the financial reporting problems at the GSEs, have led us to develop a growing consensus on GSE regulatory reform.

In the last Congress, we considered H.R. 1461, the Federal Housing Finance Reform Act, and it was approved by a vote of 330 to 91. Because this bill did not become law, we are returning to these important matters today.

The housing GSEs play vitally important roles in our Nation's housing finance system. Fannie Mae and Freddie Mac presently guarantee about $3 trillion in mortgage-backed securities. The Federal Home Loan Banks also have more than 8,100 members, possess in excess of $1 trillion in assets, and hold about $100 billion in mortgage loans.

As we have long said, we need to have strong, independent, and world class GSE regulation to oversee these sizeable institutions.

Such a regulatory system will promote confidence in the GSEs, protect a continued viability of our capital markets, ensure taxpayers against systemic risk, and expand housing opportunities. An appropriate regulatory system, like the bill we passed in the 109th Congress, should adhere to several key principles.

For example, the regulator must have a funding stream, separate and apart from the annual appropriations process. In order to be credible and effective, the regulator must additionally have genuine independence from the political system. Such independence must consist of complete autonomy from the enterprises, include sufficient protection from outside special interests, and provide for substantial insulation from political interference.

A strong regulator must further have robust supervisory and enforcement powers. In this regard, many have suggested that we should model GSEs safety and soundness regulation on that of other financial institutions. I agree with this sensible concept.

In fact, the general goal of our longstanding regulatory reform debates has been to make GSE supervision more bank-like. Any safety and soundness regulator for the housing GSEs needs to have enforcement powers on par with other Federal banking regulators. As we proceed in the coming weeks, I also hope that we will continue to remember why we created these public/private entities. We created GSEs to help make credit available to finance home purchases, because the private market was not effectively meeting credit needs.

Beyond ensuring that the GSEs can continue to fulfill their missions, we must maintain a public voice on their boards. Public participation on these boards helps to focus the GSEs on their missions. Beyond working to improve GSE regulatory oversight, we should also look at the upcoming legislative debates as an opportunity to update the statutory mission of the Federal Home Loan Bank system, and to reflect what it actually does now.

In 1999, I worked with then-Chairman Baker, to allow the Federal Home Loan Banks to provide liquidity to community financial institutions for the purposes of serving small farms, small businesses, and small agri-business customers. In its bill in the last Congress, the Senate Banking Committee had language that would have explicitly added such economic development activities to the mission of the Federal Home Loan Banks. This idea has merit, and we ought to consider it in this chamber.

In sum, in developing any enhanced GSE regulatory system, we should perform deliberate surgery. We should abstain from considering radical proposals that would undermine their charters. We should also take appropriate steps to improve their mission and performance, in addition to providing for strong, independent, and world-class GSEs.

And now, Mr. Renzi.

Mr. RENZI. Thank you, Mr. Chairman. Thank you, witnesses, for coming all the way today, and members, for joining us. I am filling in for Ranking Member Pryce this afternoon, who could not be here, as we move forward with the examination of H.R. 1427, which was introduced by Chairman Frank, along with Congressmen Baker, Miller, and Watt last Friday.

As you know, the House Financial Services Committee and this subcommittee spent countless hours studying the issue of GSE reform over the years, and the House passed comprehensive GSE legislation in the last Congress, but the bill was not taken up by the Senate.

This hearing is the first of two hearings on this bill scheduled for this week, and Chairman Frank has expressed a willingness to move quickly on this legislation. Therefore, I am eager to hear from many of my colleagues on our panel today on their opinions of this new bill, most notably the changes between last year's piece of legislation and this year's proposed new legislation.

I believe there is certainly a need for a regulator over Fannie Mae, Freddie Mac, and the Federal Home Loan Bank, to supervise both the safety and the soundness of the mission compliance of the GSEs. As we move forward, we must be careful not to negatively impact the housing market, and I really look forward to hearing the substance of your arguments, in particular, on that issue.

The bill we are discussing today is different from last year's proposal in many ways, most notably that the affordable housing fund that would be established would be funded by dedicating hundreds of millions of dollars for the construction of affordable housing. This fund would be established by using a formula based on portfolios of Fannie Mae and Freddie Mac, rather than profits of Fannie Mae and Freddie Mac.

Additionally, the bill would change the structure of the regulatory board to eliminate independent board members, and would also allow regulators to increase minimum capital standards if unsafe or unsound conditions exist. I look forward to the opinions of the witnesses, and to my colleagues today, and I thank you, Mr. Chairman, for calling the hearing.

Chairman KANJORSKI. Mr. Lynch, do you have an opening statement?

Mr. LYNCH. Mr. Chairman, in the interest of time, I have a written statement that I ask unanimous consent to submit for the record.

The only thing I would like to do at this time is to thank the panelists for their attendance, and for working with us, and helping the committee do its work.

We went down this road last year, with H.R. 1461, and I think we had not unanimity, but certainly consensus, about the better parts of that legislation. I am interested, as Mr. Renzi pointed out, in any differences between what we did last year, and some of the changes that might be warranted, especially in light of the problems that we are seeing in the subprime market lately.

And so, I will reserve my time for questions. Thank you, Mr. Chairman. I yield back.

Chairman KANJORSKI. Without objection, all members' opening statements will be made a part of the record. No objection. So ordered.

The gentleman from New Jersey.

Mr. GARRETT. Again, also, in the interest of time, to move forward, I just got here from New Jersey specifically for this hearing, and I look forward to your testimony.

I share Mr. Baker's concerns, as he has expressed over the years, with the performance of the GSEs and their finances and their transparencies. I also share the concerns that I expressed last year, when we passed the legislation out of this committee, with regard to the housing fund, and how that would have a negative impact upon the housing marketplace. And in light of the subprime market's concerns, I am wondering how that will all flesh out, as well, whether what we may be doing here today is exacerbating that problem.

As we only saw this bill drop in—as Mr. Renzi indicated—on Friday, I am still in the process of reviewing it, as well. I am pleased to see that there may be some additional safeguards, with regard to the portfolio limitations, something that Treasury, I know, was looking for, and I was, as well. So I will be looking forward to the panel's discussion on those ends, as well.

But thank you, Mr. Chairman, on the point of the hearing today.

Chairman KANJORSKI. Thank you. Our panel today consists of seven individuals: Mr. John R. Price, president and chief executive officer of the Federal Home Loan Bank of Pittsburgh; Mr. Thomas M. Stevens, immediate past president of the National Association of Realtors; Mr. John M. Robbins, chairman of the Mortgage Bankers Association; Mr. Arthur R. Connelly, chairman, South Shores Savings Bank; Mr. Michael Menzies, president and chief executive officer of Easton Bank and Trust Company; Ms. Karen Shaw Petrou, managing partner, Federal Financial Analysts, Incorporated; and Mr. Scott Stern, chief executive officer, Lenders One, and chairman, National Alliance of Independent Mortgage Bankers.

Oh, I'm sorry. Mr. Perlmutter, do you have an opening statement?

Mr. PERLMUTTER. Thank you, Mr. Chairman. When you're down here about four levels, it's hard to see. I'm not the biggest guy in the room, either.

Chairman KANJORSKI. It takes a little while, but you will get up here.

[Laughter]

Mr. PERLMUTTER. No, I just appreciate the panel's being here. I'm sorry we didn't have more of our colleagues here to listen to this testimony. I am a freshman, so I am just here to listen and learn. I have had experience with Fannie Mae and Freddie Mac when I was in the private sector, and I am just interested in your testimony today. Thank you.

Chairman KANJORSKI. Well, thank you. Mr. Price.

STATEMENT OF JOHN R. PRICE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN BANK OF PITTSBURGH, ON BEHALF OF THE COUNCIL OF FEDERAL HOME LOAN BANKS

Mr. PRICE. Thank you. Chairman Kanjorski, Mr. Renzi, and other subcommittee members, I am John R. Price, president and CEO of the Federal Home Loan Bank of Pittsburgh, and I am appearing today on behalf of the Council of Federal Home Loan Banks.

One of the 12 Home Loan Banks, Pittsburgh helps 334 member financial institutions meet the housing and community and economic development credit needs throughout Pennsylvania, Delaware, and West Virginia, just as our 11 sisters do, providing services to 8,100 member banks and financial institutions across the country.

At year end last year, we had assets of $77 billion at the Pittsburgh bank, and the system had, as the chairman mentioned, $1 trillion, on a consolidated basis, in assets.

We are cooperatives. We are not a listed company. And as cooperatives, we are active partners with our members, as they serve individual consumers, affordable housing providers, homebuilders, small businesses, and local governments around their markets.

Some of the results of this partnership include: one, helping a first-time low-income home buyer achieve ownership through downpayment or closing cost financing, which we call "first front door"; two, assisting thousands of families through the affordable housing program—more on that later; three, providing thousands of jobs at hundreds of small businesses through our banking on business program; and four, helping communities meet pressing infrastructure needs, such as water treatment repairs, through our community lending program.

As you approach the legislation here today, it is important to ask why the Home Loan Banks are so important to the Nation's economy, and why it is so important to ensure that the new regulatory structure enable, and not impede, our mission achievement.

Member institutions use the Home Loan Banks' loans—we call them advances—to meet the housing community and economic development lending needs in their local markets. Home Loan Bank advances are, in fact, the only capital market access for many Home Loan Bank members.

The Home Loan Banks' mortgage purchase programs also provide members, particularly smaller-sized institutions, a desirable secondary market alternative, and are a very important part of our mission to provide liquidity. These programs have allowed many of our smaller members to offer 30-year fixed rate mortgage products for the first time.

The Home Loan Banks also represent the single largest private sector source of grants supporting low-income housing. Home Loan Bank members utilize the AHP, the affordable housing program, to help low-income families obtain housing, and have been awarded over $2.5 billion to create more than half-a-million—520,000—affordable housing units since 1990.

A key strength of this affordable housing program is its flexibility to adapt to differing community needs across the country. Unlike some other programs, AHP funds can be used for both housing rehab and new construction, and can be used to augment other sources of funding, by filling in gaps.

And, Mr. Chairman, knowing of your personal and strong interest in, and your leadership around Home Loan Bank efforts to support community development as integral to our mission, I wanted to highlight what the Pittsburgh Bank is doing in that regard. These brief Pittsburgh examples are reflected in what the other Home Loan Banks do in their geographies.

Banking on Business, or BOB, as we call it, helps eligible small businesses with start-up and expansion costs. It is financing—this is a slice of financing that really enables a small business to be creditworthy for regular banking. Since 2000, more than $27.5 million in BOB funding in our Pittsburgh geography has created or retained over 3,800 jobs.

Just simple examples of the businesses include: the Grace Dental Practice in Cabin Creek, West Virginia; Nazar Diesel, in Jessup, Pennsylvania, a diesel engine repair business; and many others like them. This year we will be putting into the pot some $7 million in new funds for these new small businesses.

Then we have our community lending program, an $825 million revolving loan pool that offers loans to our member financial institutions for lending for community and economic development projects. A Pittsburgh member bank, for example, recently used CLP, community lending, to help three northeastern Pennsylvania—does that have a certain ring to it—three northeastern Pennsylvania municipalities upgrade their public water and sewer systems with $8 million in flexible low-interest financing.

Systemwide, the Home Loan Banks have used these programs to provide over $44 billion, financing over 600,000 housing units, and thousands of economic development projects throughout the country.

In another take on economic and community development, working with the Governor of Pennsylvania and with the Brookings Institution, the Pittsburgh Bank developed something called "Blueprint Communities Program," in cooperation with multiple partners. It's a neighborhood revitalization initiative that was launched 2 years ago.

The program, at first, involved 22 urban and rural communities across Pennsylvania, and is expanding to Delaware next year. In West Virginia, the program was announced by Governor Joe Manchin this morning.

Home Loan Bank letters of credit can be used to help members improve the credit rating for tax-exempt housing bonds, taxable community lending, and public finance transactions. Additionally, they can be used by our Home Loan Bank members to secure municipal deposits.

I would like to mention important tax legislation, which would allow Home Loan Bank member banks to assist their municipalities' non-profit care outfits, and institutions of higher learning. The bill adds Home Loan Banks to the list of GSEs that can credit-enhance tax-exempt bonds, without triggering the loss of the bond's tax-exempt character. Introduced last Congress as H.R. 5177 by Ways and Means members Phil English and Sander Levin, it has not yet been introduced in this Congress. I would like to thank you, Mr. Chairman, and many of the committee members, including Congresswoman Pryce, Congressman Bachus, and others, for their strong support for this legislation, and we look forward to working with you this Congress.

Several current issues command our attention here today. On appointed directors for the Home Loan Banks, the Council had been very concerned about the lack of appointments, and is pleased that the finance board recently issued an interim final rule establishing

a process for selecting and appointing directors. Currently, the boards of each of the 12 Home Loan Banks are actively engaged in the process of identifying and nominating candidates for these appointive directorships.

Concerning the pending GSE legislation, the Council believes it is important to resolve the uncertainty, the existing legislative uncertainty. You said that we have been 7 years at the table. It would be good to get resolution, and we support your efforts to create a strong, independent regulator for the housing GSEs.

We hope this legislation will preserve the mission of the Home Loan Banks, our regulators' independence, the system's access to capital markets, and the system's unique regional cooperative structure.

We also support the provisions in the legislation that increase the size of community financial institutions, and expand the eligible collateral to include economic development assets.

We are concerned about the inclusion of the Home Loan Banks under the deputy director proposed of FHFA for housing mission. Combining the housing mission oversight of the home loans and Fannie Mae and Freddie Mac does not reflect the unique benefits of each, and may inadvertently create homogenized regulation and programs.

Just as Home Loan Bank corporate operations and business models are really different from Fannie Mae and Freddie Mac, since we work through our members, the Home Loan Banks' affordable housing and community investment programs are different.

Mr. Chairman, thank you for the chance to address the subcommittee on these important matters, and I will be delighted to take your questions at the appropriate time.

[The prepared statement of Mr. Price can be found on page 76 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Price. The next witness will be Mr. Stevens, the immediate past president of the National Association of Realtors.

Mr. Stevens.

STATEMENT OF THOMAS M. STEVENS, IMMEDIATE PAST PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. STEVENS. Chairman Kanjorski, Representative Renzi, and members of the subcommittee, thank you for inviting me here today to testify on the important issue of government-sponsored enterprises regulatory reform.

As the 2007 immediate past president of the National Association of Realtors, and former president of Coldwell Banker Stevens Realtors, I am here today on behalf of our 1.3 million Realtors who work in all fields of commercial and residential real estate.

Fannie Mae and Freddie Mac are our partners in the real estate industry, so keeping them strong and sound is in everyone's interest. With that in mind, Realtors have six recommendations that we believe should be considered in any legislative proposals to reform GSE oversight.

First, the GSEs need a strong regulator and sound corporate governance. Regulatory oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank should be transferred to a new regulator

which has the authority to set capital standards, liquidate a financially unstable enterprise, and approve new programs and products. The regulators should also understand and support the GSEs' vital housing finance mission and the role housing plays in supporting our national economy.

Realtors also support legislative efforts to strengthen the governance of the Federal Home Loan Banks, by raising the number of independent directors, adding community and economic development expertise, and allowing appointed independent directors to continue their service until a successor is in place.

Second, the GSEs' vital housing mission should be preserved and protected. This mission ensures that Fannie Mae and Freddie Mac provide capital to the market during downturns, and use their Federal ties to facilitate mortgage finance, and support homeownership opportunities. The GSEs' housing mission is vital to the continued success of the housing market. Realtors will oppose legislative proposals which diminish that.

Third, the GSEs must be able to develop new products and programs that respond to market needs. The standards for approving new products and programs should be those contained in the Federal National Mortgage Association Charter Act, and the Federal Home Loan Mortgage Corporation Act. We support requiring the GSEs to provide notice to the regulator, so that adequate safety, soundness, and mission review can be accomplished.

We oppose requirements that could unduly delay or prevent the GSEs from developing new programs and products that support their missions.

Fourth, there should be no overly restrictive bright line test that explicitly limits the GSEs' role in the secondary market, strictly defined. Realtors believe such a test would seriously hinder important mission-related consumer outreach activities now supported by the GSEs, such as home buyer education.

Fifth, portfolio limits should be regulated, and not legislated. The GSEs' retained portfolios help support affordable housing programs, and also help provide financing for low-income borrowers. For example, Freddie Mac reports that approximately 300 million of the mortgages in the retained portfolio qualify under their affordable housing goals. We believe the best way to ensure safety is for a strong regulator to limit portfolio risk, and moderate portfolio growth, when appropriate.

Finally, Realtors support increasing the conforming loan limits for high-cost areas, and we would like to thank Chairman Frank and Representative Miller for their support on this important issue, and for including the Miller amendment language in H.R. 1427.

While the 2007 national cap of $417,000 exceeds the local median for the vast majority of housing markets, it is considerably below the local median in a few high-cost metropolitan areas. Regional adjustments will help more low- and moderate-income working families in high-cost areas qualify for conforming GSE loans. They will also expand access to FHA and VA mortgages, since those limits are tied to the conforming ceiling, and give homebuyers access to safer mortgages.

Realtors applaud the committee's current efforts to build a more robust GSE regulatory structure. Targeted reform should strengthen our housing financing system. It should not become a reason or justification for rewriting the GSEs' housing mission, or weakening the housing finance system.

Realtors look forward to working with Congress to enact meaningful GSE legislation, and I am happy to answer any questions. Thank you.

[The prepared statement of Mr. Stevens can be found on page 115 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Stevens. The next witness will be Mr. John Robbins, chairman of the Mortgage Bankers Association.

Mr. Robbins.

STATEMENT OF JOHN M. ROBBINS, CMB, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Mr. ROBBINS. Thank you, Chairman Kanjorski, for the opportunity to testify today.

Fannie Mae and Freddie Mac, the GSEs, are critically important to modern mortgage financing, and the MBA supports the role the GSEs play in maintaining and improving liquidity and stability in the secondary mortgage market. Therefore, MBA has long advocated GSE regulatory reform, to ensure that they are operating in a safe and sound manner, engaging only in activities that are consistent with their charter purposes, and are subject to reasonable affordable housing goals that do not distort the market.

My written statement is comprehensive, so I will only touch on a few highlights here today. There seems to be general agreement on the fundamental tools that the new regulator will need. MBA is particularly interested in the powers of the regulator related to the review and approval of GSE activities, ongoing and new.

Today, it is unclear whether certain current GSE activities are actually permitted. The new regulator needs sufficient authority to solve this problem. MBA has reviewed the recently introduced bill, H.R. 1427. We believe that the product approval language heads in the right direction to satisfy some of these concerns, and we strongly oppose any effort to weaken it.

We particularly support the no limitation clause at the end of this section on powers to review new and existing products or activities. This is essential authority for a world class financial regulator.

We appreciate that H.R. 1427 calculates the size of the contribution to the affordable housing fund on the GSEs' portfolio, rather than on net income. This approach would make it more difficult for the GSEs to pass the cost of their contribution on to mortgage lenders and consumers. It would also tie a benefit of government sponsorship, the lower capital cost, to the GSEs' affordable housing contributions.

Various proposals have been offered to regulate the GSEs' investment portfolios, and we are pleased with the progress H.R. 1427 makes in this area. MBA maintains that the GSEs' portfolios are an important part of their ability to help stabilize mortgage markets, and encourage affordable housing.

Because markets are dynamic, the GSEs need flexibility to adjust their portfolios to changing conditions and marketplace needs. MBA does not believe there is a need to expand the definition of high-cost areas under the GSE charters, and we respectfully ask the committee to consider the points in our written testimony.

Jumbo loan borrowers are well served by the private sector, and there is no lack of liquidity in the primary or secondary market for these borrowers. We note that H.R. 1427 requires the registration of Fannie Mae and Freddie Mac stock, but not mortgage-backed securities, and we are supporters of that approach.

Finally, Congress should strengthen both the secondary mortgage market and the Federal Home Loan Banks, by expressly affirming in H.R. 1427, that the Banks are authorized to securitize loans. Thank you, Mr. Chairman, and I look forward to your questions.

[The prepared statement of Mr. Robbins can be found on page 93 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Robbins. The next witness will be Mr. Arthur R. Connelly, chairman of South Shore Savings Bank.

Mr. Connelly.

STATEMENT OF ARTHUR R. CONNELLY, CHAIRMAN & CEO, SOUTH SHORE SAVINGS BANK, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. CONNELLY. Good afternoon, Chairman Kanjorski, Representative Renzi, and members of the subcommittee. If I might add, I would be remiss if I didn't recognize one of South Boston's own, Congressman Lynch, this week of March 17th.

My name is Arthur Connelly, and I am chairman and CEO of South Shore Bank Corp., MHC. I am also first vice chairman of America's Community Bankers, and I am testifying today on behalf of ACB.

From the outset, I would like to point out that the committee's GSE discussion draft bill is 331 pages, yet only 25 pages pertain to the Federal Home Loan Bank system. We believe this illustrates the effectiveness of a good system that is running well.

Regulations of the Federal Home Loan Bank system can be improved within the framework of a single consolidated GSE regulator, but only if adequate safeguards are provided to recognize and maintain the unique cooperative characteristics of the system.

Community banks have a rich history of superior performance in lending to minority and low-income borrowers, as well as first-time homebuyers. The affordable housing program of the Federal Home Loan Banks supports this business with advances and programs. These activities would not be possible without access to advances. The creation and availability of the Federal Home Loan Bank products, such as advances, are critical to the Federal Home Loan Bank system's ability to evolve and meet the specific needs of our communities.

We believe that any meaningful reform legislation must create a new, independent regulator with the authority to strictly prevent Fannie Mae and Freddie Mac from entering the primary market. It must also possess the regulatory and supervisory authorities

equivalent to that of the Federal banking regulators, including the authority to adjust portfolio holdings and capital requirements for safety and soundness.

The independence of the Federal regulator is also a crucial element. A structure that provides autonomy from the congressional appropriation process is essential. Most importantly, the unique cooperative structure of the Federal Home Loan Banks must be preserved.

The finance board has powers and authorities similar to those of the banking regulators in the areas of capital, activities, and supervision. They, too, should be preserved. The success of the Federal Home Loan Bank affordable housing programs suggest certain characteristics that should be fostered in similar programs that are proposed for other GSEs.

America's Community Bankers strongly recommends that any newly established AHPs draw heavily from the experiences of the Federal Home Loan Banks. The design should include private sector lenders, and developers with public and not-for-profit partners, both at the proposal stage and in project management.

We believe that the composition of the boards of each of the Federal Home Loan Banks is a vital mechanism to ensure that the governance of the banks is undertaken in an appropriate manner. Recently, the finance board passed a rule to address the growing number of vacancies on the Federal Home Loan Bank boards in the public interest director category. The rule called for Federal Home Loan Banks to provide two candidates for each public interest director vacancy on the board.

It is our preference that the boards be populated through an election, rather than an appointment process. There is no regulator who knows the strengths and weaknesses of the boards better than the Banks themselves. Even the current chairman of the finance board agrees, and has stated repeatedly that the regulator should not be in the position to appoint the regulated.

Again, I wish to express my appreciation for the opportunity to testify on this important issue. The bright issue of the Federal Home Loan Banks and a strong, well-regulated secondary market, is a necessity to the day-to-day operations of many of our community banks, including South Shore Savings Bank, and the communities that we serve.

I look forward to working with you, Mr. Chairman, and the members of the subcommittee, as the legislative process continues. Thank you.

[The prepared statement of Mr. Connelly can be found on page 48 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Connelly. Our next witness will be Mr. Michael Menzies, president and chief executive officer of the Easton Bank and Trust Company.

STATEMENT OF MICHAEL MENZIES, PRESIDENT/CHIEF EXECUTIVE OFFICER, EASTON BANK AND TRUST COMPANY, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. MENZIES. Thank you, Mr. Chairman, Representative Renzi, and members of the committee. I am Mike Menzies, president of

Easton Bank and Trust, from downtown Easton Maryland, the Goose Capital of the World.

We are a 14-year-old community bank, with $130 million in assets, and I am pleased, as vice chairman of the Independent Community Bankers of America, to testify on behalf of GSE regulations.

The GSEs are vital to our Nation's community banks. Over the last 4 years, our bank has originated over $103 million in mortgages sold in the secondary market. We have a $20 million line of credit with the Federal Home Loan Bank of Atlanta, and we use that for liquidity and asset liability management, match funding of small business loans, and to meet the community develop needs of our region.

Though very different in key respects, all three of the GSEs provide community banks with critical access to capital markets. We can offer the same home mortgage products to our customers that the largest firms offer to theirs.

ICBA supported the GSE reform legislation that cleared the House last year by a strong bipartisan vote. That bill created a world class independent regulator, recognized the unique structure and mission of the Federal Home Loan Bank system, and protected the GSE status of the enterprises.

We urge Congress in the strongest possible terms to reject proposals that claim to improve GSE regulation, but are actually designed to undermine their mission, or pave the way for privatization. There are a variety of ideas that could disrupt the functioning of the GSEs. One is to impose a cap on their growth or size. Another is to severely restrict the types of mortgage assets that could be included in their portfolios.

We strongly oppose the placement of arbitrary caps or limits, without regard to the changing needs of our customers over time. Statutory limits could compel Fannie Mae and Freddie Mac to give preference to larger volume customers, to the disadvantage of community banks and our customers. Therefore, we oppose granting the new regulator authority to limit portfolio growth or composition, except where it is truly needed to ensure safety and soundness.

The regulators should not be permitted to use capital levels to change the Nation's housing policy. Congress should maintain control over the statutory or minimal capital standards for Fannie Mae and Freddie Mac, as is currently the case. Otherwise, a new regulator could be subject to political pressure to use minimum capital authority to reduce the resources available for housing.

However, the GSE regulator should have the authority, consistent with the current authority of banking regulators, over the risk-based capital the GSEs must hold to ensure their safety and soundness. The new regulatory agency must be structured and directed to maintain the cooperative nature, operations, and mission of the Home Loan Banks.

These cooperatively owned banks are very different from the publicly-traded housing GSEs. Home Loan Bank advances enable community banks to make and hold mortgages and other types of loans in their own portfolios, loans that generally cannot be securitized.

In a complementary fashion, Fannie Mae and Freddie Mac help community banks originate mortgages that can be securitized. Congress should not attempt to draw a bright line between primary and secondary mortgage market activities. Frankly, the workings of the modern mortgage market are not as tidy as some have suggested.

For example, automated underwriting systems devised by Fannie Mae and Freddie Mac have been criticized as straying too close to the line between primary and secondary market activities. However, these systems help community banks to quickly and objectively qualify a customer for a mortgage, and determine if that loan is saleable. We want to preserve the ability of Fannie Mae and Freddie Mac to innovate to meet the changing needs of community bankers and our customers.

In the Gramm-Leach-Bliley Act, Congress allowed the Home Loan Bank members that qualify as community financial institutions to use long-term advances for community development. Not all the Home Loan Banks have implemented this authority. We don't think Congress envisioned this as a result.

Therefore, we urge Congress to clarify that, in addition to housing finance, the mission of the Federal Home Loan Banks includes this CFI authority. In addition, ICBA strongly supports a provision in last year's housing bill to increase the size of institutions eligible for the CFI program to $1 billion in assets. We agree with you, Mr. Chairman, that CFI expansion would benefit all.

Since Congress has now debated significant regulatory reforms to the regulatory oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, it's a good time to look at the oversight of another GSE, the farm credit system. This issue is especially important in a year such as this, when Congress is considering renewal of the Farm Bill.

We expect the farm credit system to attempt to expand into nonfarm lending through this legislation. We commend the leadership of this committee for your letter to the leadership of the Agriculture Committee, highlighting this potential expansion into lending under the Financial Services Committee jurisdiction.

Thanks for the opportunity to share these thoughts with you, and the views of our Nation's community bankers. I would be delighted to answer any questions, should you have them.

[The prepared statement of Mr. Menzies can be found on page 57 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Menzies. The next witness will be Ms. Karen Shaw Petrou, managing partner of Federal Financial Analysts, Incorporated.

STATEMENT OF KAREN SHAW PETROU, MANAGING PARTNER, FEDERAL FINANCIAL ANALYSTS, INC.

Ms. PETROU. Thank you. It is an honor to appear before this subcommittee to discuss the urgent need for GSE reform. I last did so in June of 2003, shortly after the problems at Freddie Mac became apparent. I said then that those were deep problems that warranted action to reform the Office of Federal Housing Enterprise Oversight, or OFHEO, and I worried then that Fannie Mae would

soon follow Freddie Mac, and shows signs of significant internal control problems, as well.

At that time, those were debatable propositions, and of course, now, they're not. This committee has worked very hard, and there is clear consensus now on the need for world class and bank-like regulation. The challenge, I think now, is not on the overall need for the legislation, because that debate has finally ended, but rather, on what constitutes a bank-like world class framework, and there is still some debate.

H.R. 1461, as passed by the House in the last Congress, was a significant improvement over current law, with regard to the safety and soundness governance of all of the housing GSEs. And H.R. 1427, as introduced on Friday, is, I think, a still more sound and far-reaching piece of legislation.

If I may, I would like to quickly talk about some of the key provisions in the new bill, H.R. 1427, highlighting how they compare to the powers that the banking agencies have. I would like to focus quickly on the more controversial issues of capital, new product review, and the portfolio, but also mention several other critical prudential provisions—that were in—H.R. 1461 and are now in H.R. 1427. You all know all too well how things can end up on the cutting room floor in the middle of the night, and some of these provisions that aren't drawing as much attention are truly critical to a bank-like, world class regulation. So I would like also, quickly, to mention them.

On capital, it is, I think, very important to provide, as the legislation would do, the new regulator with flexibility to set minimum and risk-based capital thresholds. We have given that to the banking agencies, because it is critical that capital rules not only reflect risk, but also anticipate it.

The capital frameworks for Fannie Mae and Freddie Mac were set in 1992, and that for the Home Loan Banks in law in 1999. And you know all too well the many changes in the markets, now that very troublesome problems in subprime, but before that, the growth of derivatives, and many other issues that were not anticipated when the statutes went into the depth they do on the capital frameworks now in place.

The regulators should be freed, as the banking agencies are, to set capital appropriate to risk. And, indeed, you may wish to consider creating this same incentive for the GSEs that you have for the banks, that they not only be adequately capitalized, but also, in fact, well capitalized, to create a strong bulwark against any call on the taxpayer.

H.R. 1427 is a significant improvement over the prior approach to new product review, because it provides for full prior review by the regulator, and public notice and comment of new GSE ventures.

Congress, when you last looked at this issue—did so in Gramm-Leach-Bliley in 1999—and you then required the Federal Reserve and the Treasury to issue public notice and comment of any significant new ventures for financial holding companies. That is how Congress learned of the proposal to permit real estate agency and brokerage powers. It is how other interested parties became engaged, and it is the same early warning process that should apply

to the GSEs, especially in light of their far greater market power than any single private sector institution would have.

H.R. 1427 has a compromise approach on the portfolio that gives the regulator considerable discretion, as Chairman Bernanke has suggested, that this be used to focus on affordable housing. And certainly, there is a good deal more that could be done to serve underserved borrowers in a safe and sound way by Fannie Mae and Freddie Mac.

Some have suggested that this portfolio limit is not bank-like, that nothing like that applies to the banks. And I would just like to mention that, indeed, there are numerous express statutory provisions about what banks may hold, and how much they may hold.

Draw your attention, for example, to the provisions in Gramm-Leach-Bliley that dealt with holdings of private equity, and the prohibition against banks holding any form of assets related to commerce. I know those are the major three controversies. But if I may, I would like just quickly to mention two other critical provisions in H.R. 1427.

One is in section 102, which details the prudential standards, rules, orders, or guidance that the new regulator must issue. This is stronger than the Senate bill, which made it discretionary. It is important to keep not only the firm directive to the regulator to issue these standards, but the full list that you have in the legislation, to get a rule book in place as quickly as possible for all of the GSEs that approximates the standards in place for insured depositories and their holding companies.

Finally, the House bill also has extensive provisions related to GSE corporate governance, expressly governing Fannie Mae and Freddie Mac. These, too, should be retained because we know from sad experience the significant problems at these enterprises, and the lack of market discipline that applies to them.

Any questions about the statutory authority of the regulator to ensure effective corporate governance at the GSEs should be retained.

I very much appreciate the opportunity to appear here today, and I would be happy to answer any questions you may have.

[The prepared statement of Ms. Petrou can be found on page 69 of the appendix.]

Chairman KANJORSKI. Thank you very much, Ms. Petrou. Our final witness, Mr. Scott Stern, chief executive officer, Lenders One, and chairman, National Alliance of Independent Mortgage Bankers. I will just add I didn't believe you were old enough to hold that role.

[Laughter]

Chairman KANJORSKI. It has been proven to me that you clearly are a Wharton man. Anybody who is a Wharton man certainly is qualified.

STATEMENT OF SCOTT STERN, CHIEF EXECUTIVE OFFICER, LENDERS ONE, CHAIRMAN, NATIONAL ALLIANCE OF INDEPENDENT MORTGAGE BANKERS

Mr. STERN. Thank you. Chairman Kanjorski, Representative Renzi, and members of the subcommittee, my name is Scott Stern, and I am chief executive officer of Lenders One of St. Louis, Mis-

souri, and chair of the National Alliance of Independent Mortgage Bankers. We appreciate the opportunity to present our views on the impact of proposed legislation on the GSEs.

Since this is the first time our group has testified in front of this committee, let me say a quick word about Lenders One. We are the Nation's largest mortgage cooperative. We play a unique role in the mortgage industry. Much like the agricultural co-ops that enable family farms to survive in an era of large-scale agri-business, Lenders One permits locally owned mortgage bankers to compete in a rapidly changing marketplace.

We are owned by 100 shareholder companies who collectively originate $40 billion annually in mortgages, including low income and minority lending. We have originated almost 2 million home loans since 2000. The mission of Lenders One and AIMB very informs our analysis of GSE legislation.

Like everyone at this table, we support a strong regulator with appropriate powers to regulate the safety and soundness and mission-related activities of the GSEs. Our written testimony outlines our more specific positions on issues such as portfolio, capital, loan limits, and program approval. So we will focus today on what we believe to be the most crucial aspect of the discussion.

If anyone needed to be reminded why Congress created the GSEs, you need look no further than the front page of the Wall Street Journal on most any day of the past 4 weeks, or look at CNBC, where it seems that every 20 minutes or so they run a segment called "Mortgage Meltdown," a term for which you will find 41,000 hits on Google this afternoon. Or, at this front page headline in yesterday's New York Times, "Mortgage Crisis Looms."

I don't personally believe we are approaching a broader mortgage crisis, but there is clearly a growing perception that we could be headed in that direction. But my confidence in the Nation's housing finance system remains high. Tomorrow, I will go back to St. Louis, and I and my member companies are going to keep making mortgage loans. Why am I so confident at this time of market uncertainty?

Because even at this time of insecurity about the mortgage markets, I know with complete and utter certainty that if I make a good loan, I will have a buyer: Fannie Mae and Freddie Mac. I can't make a loan unless I can sell that loan.

You see, that's the way the mortgage business works. And even though, in some segments of the market, investors are disappearing faster than an ice cube on a hot summer day in D.C., I know Fannie Mae and Freddie Mac are going to be there to buy my loan. That's why they were created, and that's the brilliance of the system set up by your predecessors almost 80 years ago, at the establishment of Fannie Mae, and the concept of a government-sponsored secondary market.

While other investors can and do walk away, Fannie Mae has to be there. Simply put, Fannie Mae and Freddie Mac are the firewall that safeguards the Nation's housing finance system, and its borrowers, from market shocks and excessive volatility, by providing confidence in mortgage capital markets.

I will frankly tell you that the GSEs are not our biggest business partner for our companies. Really, not even close. But they are,

nonetheless, crucial to me and my members in the housing finance system. Our confidence that the GSEs will be there at a size and strength that enables them to keep the market stable, even in volatile conditions, is what makes the system work. To us, keeping the GSEs at a vigorous scale and strength to safeguard that confidence is what the debate over a GSE bill is all about.

We support the general approach of H.R. 1427 introduced last week by Chairman Frank. The bill would create the strong regulator we have all supported. However, we do believe the bill requires certain clarifications to ensure that the new regulator's power and authority is never used to diminish the one sector of the housing finance system best shielded from market uncertainty. You will find our detailed positions in our written testimony.

Mr. Chairman, we appreciate your leadership on this matter, and we are grateful for the opportunity to share our views.

Chairman KANJORSKI. Thank you very much, Mr. Stern. Without objection, the written statements of all the witnesses will be placed in the record in their full text.

And I have one other unanimous consent to insert into the hearing record statements from: The National Association of Federal Credit Unions; The National League of Cities; The American Bankers Association; The Pennsylvania Bankers Association; and The Asian Real Estate Association of America. Without objection, they will be inserted in full in the record.

I think it would be fair to comment that the seven witnesses, so far, liked the product as introduced on Friday by Mr. Frank. Is that a reasonable statement? And we just have a few disagreements, or twitches that should be made or considered?

I want to address myself to Mr. Connelly. I am one of the individuals who has been struggling over the appointment of members to the board, both to the Federal Home Loan Bank and to Freddie Mac and Fannie Mae, and your observation that members of the board should be elected, as opposed to being appointed, interests me.

I totally agree with that concept, except that the peculiarity of these organizations, having an outside mission created by the Congress, I feel that there is less likelihood of an incestuous relationship existing if the outside appointees are made, in fact, by the normal members of the regulatory board. They have interests slightly different, in terms of mission, and whether or not, over a period of time, particularly the Federal Home Loan Bank system could be lost in its mission without any way of the Congress or anyone else correcting the mission, or bringing about or even finding out that the change of the mission has occurred.

Why do you find it so difficult to have either the nominating process that is suggested in the bill, or the old process that the regulator make the appointment of the outside directors?

Mr. CONNELLY. Well, Mr. Chairman, first I think that we're in a new environment today, coming under SEC registration. It is important that the Federal Home Loan Banks should have the ability to pick the brightest and the best, and most representative of the constituencies, the skill set that are required.

Chairman KANJORSKI. Who is the constituency, though, in your mind?

Mr. CONNELLY. Well, there is a mission, you know. The mission is to serve the credit needs, and what not. The cooperative nature of the system suggests that it is owned by the bank members and insurance company members. However, we are very mindful of the mission to provide for the credit needs of our communities that we serve, as well as the housing mission, the affordable housing program, which we think is a model program.

And it just—under the current proposal, providing several suggestions, which is essentially what this amounts to, doesn't necessarily guarantee that we get the most qualified people for the board. And it perhaps dilutes the pool for future appointments, because if you don't happen to be in the first successful round of people who are selected, you may not be willing to stand for consideration the next time around.

Chairman KANJORSKI. Well, you know, I had a long discussion with the present regulator on that very issue not too long ago. Sometimes there is a tendency to define the most qualified as either academically most qualified, business success most qualified.

And of course, the mission involves the involvement with the community, with economic development and with housing. And very often, the appointments are not necessarily those that would be made to private boards, but come from the billing associations, the Realtors, and average people in the community, to get input on the mission from those types of people.

On the other hand, the present regulator suggested how nice it would be if college presidents, for instance, could be put on the board. I don't want to denigrate my opinion of college presidents, but very often I find them captives of the establishment, and the very point of the mission is to make sure that these entities don't become captives of the establishment.

So if you empower the internal board to make the appointment of the outside board members, their natural inclination will be to add to the board people more like themselves, who are part of the establishment. And over a period of time, it seems to me that they will naturally gravitate toward not necessarily attending to the mission of housing or economic development, but will attend to the mission of profit. It's very tempting.

Not that I am against profit, but we didn't establish this as an entity for pure profit. Because if it is pure profit, then the private sector should run the operation, and we should step out of it. On the other hand, I'm a very strong supporter of the cooperative system, of the Federal Home Loan Bank system.

So my question to you is, even though you disagree with what's in the bill, is it so fundamental a disagreement on your part that we should scratch the bill if it's in there?

Mr. CONNELLY. No, I think the bill is more important than anything at this point in time. As a member of the board of the Federal Home Loan Bank of Boston, though, I can tell you that we have identified the skill sets that are critically necessary to complement the board.

Somebody, for instance, who is familiar with not necessarily all of the public appointees, but someone certainly who is familiar with the securities business, somebody who understands the particular nuances of leveraging, of hedging, should be represented

from among those many people that would constitute the public interest directors on the Boston board.

Chairman KANJORSKI. Why shouldn't that be an appointment of the board, of the regular election process, to get that kind of expertise?

That point was made to me, to appoint someone who understands derivatives. And quite frankly, my response to that was I think the present directors are paid, about $19,000 a year? If you could find an expert on derivatives for that price, you should hire him and recontract him out, because—

Mr. CONNELLY. Point well taken, Mr. Chairman.

Chairman KANJORSKI. My intent in structuring these appointments is to make sure that, regardless of what political party controls the Congress, or what political party controls the White House, that over a long period of time the mission remain in the public interest for housing and for economic development.

Mr. CONNELLY. And I think we—

Chairman KANJORSKI.—including that broad knowledge base into the board, sometimes even anti-establishment type individuals, may be very helpful.

Mr. CONNELLY. I couldn't agree with you more in that respect.

Chairman KANJORSKI. Very good. Now, the one other question that I am also—I am past my 5 minutes. I am verbose. That is the pleasure of the Chair.

The one question that you raised, Mr. Menzies, is something that we have not passed over lightly, and that is to try and see whether we could eventually consolidate GSEs under one jurisdiction, and particularly as they apply to farm credit.

I guess I have to plead a little ignorance in what you anticipate the Agriculture Committee doing, or being requested to do. Are they enlarging the loan capacity of farm credit agencies to circumvent the banking system? Is that what your primary thrust is?

Mr. MENZIES. Mr. Chairman, "circumvent" probably wouldn't be an apt description. However, we believe the farm credit system, which is the only retail, direct-to-the-consumer GSE, does, in fact, wish to expand its income source, and does, in fact, wish to expand its role, if you will, by lending beyond its original mission to just support farming.

And we believe that they would like to go into small business and lending into other activities that, currently, the banking industry supports quite nicely. That's the basic issue.

Chairman KANJORSKI. What—

Mr. MENZIES. The question is, do we need the farm credit system of this Nation to further expand its retail influence into small businesses and the like?

Chairman KANJORSKI. So it's not just who may have jurisdiction over these entities here in the Congress that you're worried about? There is a thrust to substantially change and enlarge the mission of these entities, is that correct?

Mr. MENZIES. Yes, sir. That is correct.

Chairman KANJORSKI. Well, I have the assurances of the chairman of the Agriculture Committee that it is an issue that he is aware of. But quite honestly, I tend to sympathize with his position, and that is that we have cut out a lot of issues in the 110th

Congress, and that may just be one issue too far, but that we should keep it in view, and try to coordinate something eventually.

Watch it, and we will have to watch in this committee, and in the Congress, that something isn't in the Agriculture bill that goes way beyond anyone's intentions.

Mr. MENZIES. If it remains on your radar screen, we will be grateful.

Chairman KANJORSKI. It is. I know how active all of you are in the use of the Federal Home Loan Bank system for rural and ex-urban economic development, and I see a great void in the Federal system and in the private sector.

Financing is much easier in urban areas; as you move out from the urban areas, it's much more difficult. Even our government programs are much more difficult to comply with. And it seems to me that since the populations have been moving out of cities into urban and suburban areas and rural areas, that we develop means and mechanism, both in the private sector and in government-sponsored enterprises, to have a uniform standard to meet these needs that are less shocking.

I will give you an example—the rural development program, and business loans, and business guarantees. They are great on paper, except they really don't apply in most areas—particularly Pennsylvania, because Pennsylvania is a State of very small communities—but, they are bunched up alongside other communities which are really tied into a very large community.

By virtue of the fact of their structure, they have been barred from giving government guarantees, even in communities of 2,000 or 3,000, if they are considered to be in an urban area, which nobody can quite define to me. They just have a map, and they say, "If you fall in the yellow, you're in an urban area," and yellows usually are wherever there are masses of people, including the rural and suburban and ex-urban areas around concentrated cities.

It would just seem to me that what I am trying to do is create the availability of community and economic development funds on a rather uniform basis with a relative cost that is similar, regardless of the size of the entity, or population of the entity making the loan. The reason for this is so that we can get the marketplace to really function well, that you don't have to start sitting down with a pencil and a paper, and try to figure out where you have to move your business in order to qualify for what type of loan, or what type of interest rate, etc.

But I do want to assure you that we are paying particular attention to the fact that, in an ideal world, if we were starting everything again, all of these financial institutions should be incorporated within the jurisdiction of this committee, so we could handle them more fairly. But if you know anything about the Hill, once a designation of jurisdiction is made, it takes extreme seniority and a little help from God to change that jurisdiction. But we're working on it, and we are optimistic.

Mr. MENZIES. Thank you. Thank you, sir.

Chairman KANJORSKI. Now that I have exceeded my 5 minutes, Mr. Garrett of New Jersey?

Mr. GARRETT. Thank you, Mr. Chairman. Again, thank you to the members of the panel. And as I indicated at the outset, I had

the opportunity, as I guess you have, to try to go through this over the weekend. Even after the testimony, I still have some serious concerns with the legislation, as it now stands, and hope that we do not rush to judgement on it, and move too quickly on the matter.

I will note, on the positive side, that there are a couple of elements to the bill that I agree with, that we have a much stronger capital requirement in the legislation, that I believe also addresses the issue, as has been addressed by this panel, of a clear line on the primary and secondary mortgage market activities.

But in regard to the issue discussed here, the portfolio issue, and also one of their core functions of the GSEs, my initial feeling is that the legislation really doesn't go far enough in reigning them in, and may, in fact, encourage the GSEs to actually expand on their portfolios even further. The Federal Reserve indicated that, "The GSEs' portfolios appear to have no material effect on the cost or availability of residential mortgages."

In fact, Chairman Bernanke, in a speech last week, noted, "Contrary to what would be expected if the GSE portfolios lowered the funding cost of mortgages, over the past decade or so the spread between yields on 30-year fixed rate mortgages and treasuries of similar duration has tended to rise in periods in which the GSEs have increased the share of single family residential mortgage held in their portfolio, and to fall when the GSE share has fallen."

He went on to specifically state, "Due to the GSEs' support for affordable housing," and he answered his own question by saying, "At the present time, Fannie and Freddie fail the test."

So, I believe this bill will unwisely tie the amount that the GSEs hold in their own portfolios to what they contribute to low-income housing. And I have said this in the several hearings that we held on this last year, when we talked about this new function of GSEs, as far as what I call a mortgage tax increase, the housing fund, that may have a negative impact on the overall housing market, as well.

Basically, as Mr. Stern has said, we have seen rises and declines in the housing market. Is this the time that we want to be adding yet another tax, overall, which eventually goes down to the consumers?

So, I will initially just turn to the panel, if you would wish to address either one of those issues, as far as this mortgage tax increase that this bill would include, and the fact that we may be exacerbating the problem of the portfolio size, as well.

Mr. ROBBINS. Let me comment, if I could. The GSEs' portfolios are needed for liquidity in the marketplace to support it. If we go back to 9/11, the meltdown of—the liquidity crisis in 1998, the First Gulf War, the market was disrupted by those events, and can be disrupted by other cataclysmic events.

Mr. GARRETT. I appreciate that comment, and actually, Mr. Stern was making that same sort of suggestion earlier, in his testimony, that as any day you said you open the paper, it goes up and goes down, what have you, as far as overall economy in the housing market.

The testimony that we received on this issue in the past when that was raised was just contrary, unfortunately, to what you're

saying and what Mr. Stern was saying. What this testimony and the evidence indicates, reports and studies of GSEs says that instead of stepping into the market to pick up where you would hope that they would do the good job that they are supposed to by their mission, instead what they do, in essence, is to cherry-pick the market, and that the private market still has sufficient capacity to address it, but the GSEs basically come in as the suitor of the best portion of the market, and takes that. And that is what they have been holding primarily in their portfolio, even during those downtimes, when we wish that the GSEs were doing the job which was the core mission to satisfy the underlying market.

Mr. ROBBINS. I appreciate what you're saying, Representative. What I was saying is in this particular case, there was a day or two immediately following all of those events where there was no market, other than Fannie Mae and Freddie Mac. The private market was not there to support—I sold mortgages through those markets. And that's the kind of events that need the liquidity that we are talking about.

What the MBA proposes is that a world-class regulator—

Mr. GARRETT. Yes, but again, that goes to what—Chairman Greenspan testified on those points, because we addressed the exact same points after the fact.

Mr. ROBBINS. Well, I can tell you, after the First Gulf War, there was no market for 2 days following the announcement of the war. The mortgage-backed securities market was unavailable, while it tried to reprice itself.

Mr. GARRETT. And GSEs were in during those 2 days, picking up all those periods?

Mr. ROBBINS. That's correct.

Mr. GARRETT. And that lasted after the 2-day period?

Mr. ROBBINS. They posted a price, if memory serves, the afternoon that it was announced, and had a price the following morning.

But beyond that issue, that's why we feel that a world-class regulator should make the determination on what that portfolio size should be, and what the leverage should be on that. We know that outstanding mortgage debt is going to grow, according to Harvard University, some $20 trillion over the course of the next 20 years or so.

And so, it is inconsistent today to sit there and think about what would be the right number to attach to the GSEs. That's why a strong regulator, world-class regulator, should be there, both as the market rises and falls in size, or rises and falls, should be the one to make that determination.

Mr. GARRETT. Okay. I saw a lot of other hands.

Mr. MENZIES. I would be the very last to question Mr. Bernanke's economic logic on the rise and fall of prices in the secondary market. As a community banker, I do know, however, that we need access to that market. And the 5,000-some community banks that belong to ICBA are basically small banks. We are little banks, and I don't know what we compose of the total secondary market, but it's not a whole lot; it's a fairly small percentage of the whole.

So, having access to that market is critical. If you were to theorize that reducing the size of the portfolio, and setting capital lim-

its, and reducing the quantity of loans that Freddie Mac and Fannie Mae can guarantee would, in fact, improve market prices, that is possible, I guess.

Mr. GARRETT. Well, no one is suggesting that would reduce the amount of loans that they are—would be able to go secure from them, but simply that they would no longer be holding the mortgages as they have, but instead would do what their core function is, to securitize those loans.

Right now, one of the other testimonies was a testimony that they are only holding around a third of their loan in their—which is basically their core function—the secondary market loans.

By reducing their overall portfolio to just a limitation in that area, how would that reduce your ability of liquidating in a market, if they were securitizing the rest of the market?

Mr. MENZIES. Well, yes, if you believe that is the case, then that would not hurt community banks. I think our concern is that it could hurt community banks if it reduced our access to the market.

Mr. GARRETT. Yes. Thank you, Mr. Menzies. Mr. Price? Yes, sure.

Mr. PRICE. Yes. If I could speak briefly to the point?

Mr. GARRETT. Sure.

Mr. PRICE. The Home Loan Banks are—and historically have been—a source of liquidity. In fact, they were an initiative of Herbert Hoover. And in December of 1931, he proposed both the Home Loan Bank Act, and something called the Reconstruction Finance Corporation. And on January 22, 1932, both bills were passed on the same day, by the Congress.

The purpose of both, the Home Loan Bank Act and the Reconstruction Finance Corporation, RFC, of which Roosevelt made much greater use later, was to provide liquidity to the financial system. And the Home Loan Banks were limited at the time—as until recently—to the thrifts, whereas RFC made liquidity available to commercial banks, insurance companies, railroads, and through the banks for public finance to municipalities, as well.

So, historically, our mission has been liquidity. And that is what we continue to be. We are an accordion. We will close down our balance sheet if members say, "We don't need the money," we don't roll over our loans. We will go to the market immediately to fund a loan if a community bank comes into us at 3:00 in the afternoon. We are in the market through our combined office of finance multiple times every day.

So, liquidity is our business, and we think that, at least as far as the primary market is concerned, that that's why we are here, and that's why we are a tool of great usefulness to the folks you see around the table.

Mr. GARRETT. Well, would any of you, then, short of having a set number—as I think Mr. Menzies and other have stated, that you wouldn't want to have the lack of flexibility by the regulator—would any of you adopt an approach that Chairman Bernanke has suggested to address the issue of the affordable housing end of it, which he said—and I sort of alluded to this—he said, "A straightforward means would be of anchoring the GSE portfolios to a clear, public mission would be to require Fannie Mae and Freddie Mac to focus their portfolios almost exclusively on holdings and mort-

gages or mortgage-backed securities that support affordable housing."

And then he points to your point, "The evolution of mortgage markets since the GSEs"—since back then—"were created, strongly suggests that a concentration on affordable housing products would provide the greatest public benefit. Markets for the more highly rated assets, including most residential mortgages and the pools of the MBSs backed by such mortgages, have become extremely deep and liquid. With more than $25 trillion in outstanding instruments, these markets are international in scope, and market participants include thousands of banking organizations," and so on.

So, his suggestion is that in the other market that the liquidity is much greater. But at that area that you're talking about, which was the original mission, is not so much. So does anybody want to comment on Chairman Bernanke's suggestion, maybe we should not put a limit on it, total number on it, but give the regulator some direction, as far as what the portfolio should be aimed at?

Mr. CONNELLY. We support—America's Community Bankers supports a Federal Home Loan Bank like an affordable housing program that the regulator would have the power to oversee. And I think we have seen it work so well with the Federal Home Loan Bank system, where the Federal Home Loan Bank's contribution is tied to its profitability, along with its other obligations, and what not. And we have—there are so many creative programs that have come about as a result to create housing for low and moderate-income people.

And maybe one of the more spectacular examples would be something like an equity builder program that the Boston bank has created, where it helps people who wouldn't be able to get into the market. It helps them with a portion of the downpayment, and a portion of money to help cope with discounted entrance fees, legal fees, and what not.

So, I think the model that is working would be the Federal Home Loan Bank model, and we would encourage the committee to look at that model.

Mr. STARK. Representative Garrett, if I could also comment, the portfolio, to kind of look at it for what it is, is a source of revenue for the GSEs. But they do use that revenue to build the size and scale to be relevant, and to provide liquidity to the marketplace.

The holding of mortgage assets is somewhat of a zero sum game. If you take assets away from one entity, such as a GSE, it doesn't disappear; it is reallocated. And in the case of the American housing finance system, it would be reallocated to large-scale American financial institutions and global financial institutions.

The only difference is those financial institutions don't have a charter, or a mission to serve the housing finance system, whereas Fannie Mae, Freddie Mac, and the Federal Home Loan Bank system do. To arbitrarily limit the size of their portfolio based on the size of their affordable housing mission, or their affordable housing loans, limits their revenue that they could make, and it limits the service that they can provide to the housing finance system, in general.

The NAIMB and Lenders One would strongly oppose a policy to limit the size of their portfolio to their housing, low-income—

Mr. GARRETT. They could still increase, if they were just earmarked for the affordable housing segment, but I appreciate your comment.

Mr. ROBBINS. Could I add just two more very quick comments to this?

Number one, we have seen the largest mortgage markets in history over the last 5 years—international buyers come into our marketplace and purchase strips of our securities to sizes never seen before, but that's no guarantee that those same investors are going to support this market to the size and extent that they have for the last 5 years.

It is incredibly important that the GSEs maintain some flexibility relative to the size of their portfolios if, in fact, an American real estate-based security does not become the most popular financial asset to buy in the world.

Number two, in many States, $417,000 is affordable housing.

Mr. GARRETT. Thank you.

Chairman KANJORSKI. Thank you, Mr. Garrett. Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman. First of all, since we have hashed this bill out in the past, we certainly have fallen to focusing on those few areas that we still have some level of discontent on, and I think that's good.

Let me begin by saying, Mr. Connelly, you have at least three branches of South Shore Savings Bank in my district. I know you have one in Stoughton, you have one in Braintree, and you have one in—let me think, where else—East Bridgewater.

Mr. CONNELLY. Glad you're keeping track.

Mr. LYNCH. You do a good job. Mr. Chairman, Mr. Connelly is our version of George Bailey. I don't know if you saw that movie, "It's A Wonderful Life." He is a good corporate citizen, and not only in the financial sense, but also like a lot of our bankers, our community bankers, very much involved in the civic life of our communities, and the charities, as well.

But it's important that we get this legislation right. Mr. Stern was kind enough to mention the article yesterday by Gretchen Morgenson in the New York Times about the looming mortgage crisis, and of course, she was speaking directly about the subprime market, but I think it affects all of us here.

Since we are looking at this new regulator model, I wanted to ask a few of you—and, Mr. Robbins, you had mentioned in your written remarks—which were very good, by the way—about the bright line distinction that you would like to maintain between the GSEs and the primary market, and now we have a situation where we have had a fairly sharp uptick in the number of delinquencies associated with subprime mortgages. We have had two dozen mortgage lenders either fail or close their doors.

We are waiting, as Ms. Morgenson noted yesterday, for the rating agencies—Moores, and Standard and Poors—to downgrade a lot of these mortgage-backed securities in the coming weeks and months, which I know as a former—I used to sit as a director on a pension fund—it will require a lot of our pension funds and insurance companies, because they're not allowed, under their guidelines, to hold lower classes of securities once they're downgraded; they will have to sell.

That whole downgrading and sell-off is likely to drive these securities even further downward, and I am just concerned that may have a dramatic effect, generally, on the distribution of capital for mortgages.

I would like to ask all of you, what do you see the effects of that being on your businesses, at least in your part of this mortgage industry? And what might we do here, in drafting this legislation? Can we learn some lessons from this meltdown in the subprime market? Is there something we can do to guard against that? Or, should we? Some people may say that this is the market just working, so leave it alone; this is the way it happens.

But I would like to get your thoughts on it, if I could.

Mr. CONNELLY. Mr. Lynch, from our perspective, I think probably the strongest thing that this committee could do would be to appoint a world-class regulator with the appropriate powers to oversee and regulate good behavior.

Mr. LYNCH. But, Mr. Connelly, that would necessitate—well, it would be in conflict with the idea that the regulator should not be active in the prime mortgage market in a way—the—some of the failings of these mortgages in the subprime market are happening in the origination process, where you have people who shouldn't be getting loans but are, in fact, getting them.

It deals with the new program issue about new programs coming out, and you're going to have a regulator back here, saying, "No, that's not an approved product," so it's going to affect some things that are helping our low- and very-low-income folks out there.

It's just that some of what you're asking for and agreeing to may have an effect on some of the issues that you're concerned about, and I'm wondering how that's going to play out.

Ms. PETROU. It would seem to me, sir, that the key issue, as we look at the subprime situation, first from the GSE point of view—and there I think it's quite troubling—we don't have good numbers from Fannie Mae, and Freddie Mac. As you know, that's part of the problem this legislation is hoping to solve.

But if you accept for the moment that the subprime sector is about $1 trillion, and then you look at the numbers that are available on the holdings of private label securities that Fannie Mae and Freddie Mac have, the bulk of which—again, we're not sure, may come from that market, and probably do—Fannie Mae and Freddie Mac seem to have about 25 percent of the subprime, secondary market.

Now, they are holding only the AAA traunches, i.e. the highest quality, or the lowest risk pieces. But behind that, are the mortgages themselves, and the borrowers. And I think what really concerns me is that we need to bring together in a new regulator, someone who looks both at the risk pieces, but also at the market issues.

Because if a GSE is holding a AAA traunch, it may be protected. But that doesn't mean a vulnerable borrower whose mortgage was booked without any regard to capacity to repay is facing foreclosure. And that is a real tragedy. So we need to bring that together in a far better regulator than we have now, in my opinion.

Mr. LYNCH. Well, thank you. Mr. Stern, do you have anything to add?

Mr. STARK. It's our opinion, in looking at this issue, that, in many cases, it was not actually the product, an individual product, responsible, but in fact, a layering of risk—in many cases, loan-to-value, credit, documentation.

We believe that a lot of the products in the marketplace now were responsible for increasing homeownership in minority borrowers, and across America, such that we now have the highest homeownership rates that we have ever seen.

We do believe that there are aspects, in terms of education, and in some cases, that we need to do a better job of policing our own industry for our long-term reputation, to make sure that when a borrower achieves the American dream through purchasing a home and getting a mortgage, it's for the intention of them being in the mortgage for a long time, because we do know some of these products contain features that set the borrowers up for risk.

However, with regard to program development, we believe the regulator should only oversee program development when there is an issue of safety and soundness, or the mission, as it relates into the GSEs, their role in providing assistance for origination, technology such as DU, for example, should not go through the laborious process of full posting and comment review, which takes a long time.

Mr. LYNCH. Right. And just in closing—I agree with most of what you just said—but I think that one of the financial analysts yesterday in that New York Times article said that about 20 percent of the subprime, actually BBB bonds, that had been issued during 2006 will be downgraded in the next few months.

Also, I think it was noted that some of these loans were no money down, some of the loans were so-called—this is the term they used—"liar loans," where there was very little information that was required in the application for the loan, and very little verification of an ability to repay.

I am just concerned that we might not—if we're going to maintain that bright line between the GSE operating and the secondary market, and we still have these flaws in the origination process in the primary market, that we still may be having these problems, and I'm just wondering if there is a way we can get at that.

Mr. ROBBINS. Yes. Mr. Chairman, a couple of thoughts. And to frame the size of the issue, to begin with, there are approximately 50 million home loans in the United States—13.5 percent of those are subprime loans, with a foreclosure rate slightly over 4 percent today.

Mr. LYNCH. That's for the whole market?

Mr. ROBBINS. That's for the subprime market, alone. The highest—

Mr. LYNCH.—say 12.9 percent, almost 13 percent—

Mr. ROBBINS. That's total delinquencies.

Mr. LYNCH. Yes.

Mr. ROBBINS. I'm talking about loans actually entering foreclosure.

Mr. LYNCH. Oh, I see. Okay.

Mr. ROBBINS. The highest in the modern-day era, which includes hybrid loans, was in 2000 at 9.35 percent of all loans entering foreclosure. Today, because of mitigation techniques that the industry

uses, about 50 percent of the subprime loans that enter foreclosure actually go through the entire process, and only about 25 percent of all loans.

That being said, if you said that the all-time high was exceeded, and 10 percent of all subprime loans went into the foreclosure process, something like 5 percent will ultimately be foreclosed against, which means that about 95 percent of the recipients of subprime loans will ultimately be successful homeowners.

This is important, only out of the respect that we know that 45 percent of the loans that were made were to people or borrowers to buy homes. And so—and those were people that, in all probability, could not use traditional sources in order to obtain that.

Mr. LYNCH. Right.

Mr. ROBBINS. That being said, there is absolutely no question that there were lenders with this product that got very aggressive in their underwriting, in order to grow a market share, as happens in those kinds of cycles, and ultimately, the market being extraordinarily efficient, has punished them pretty severely, if not totally, for that aggression.

The market itself, as I said, is extraordinarily efficient. It is much faster than most regulators and legislators in the sense that it—the aggressive parts of those products, or product features, have already been curtailed dramatically by institutional investors all around the world.

And, quite frankly, the loans that are being made today, including subprime loans made today, are probably the best group of loans that have been made in the last 5 years, so we would argue that the market is extremely efficient, and has already moved to correct the mistakes that were made by the more aggressive companies.

Mr. LYNCH. That's a fair answer. Thank you, Mr. Chairman. I yield back.

Chairman KANJORSKI. The gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thanks, Mr. Chairman, and I am going to apologize, because I'm about 10 steps behind everybody here. We are talking about Friday's bill as compared to last year's bill, and my first question is, what were the excesses of Fannie Mae, or Freddie Mac, or the Federal Home Loan Bank organization that we're trying to solve by the bill that was coming down the pike last year, and has that been improved this year?

Mr. Stevens, or Mr. Robbins, could you tell me what those excesses are that we're trying to do by this super-regulator, just to get me into the right timeframe here, because we're talking about the subprime loans, and subprime loans, that's today's problem. And you know, we had a lot of money chasing some lousy loans, quite frankly. That's the problem there.

And, Mr. Stern, you know, you have Fannie Mae and Freddie Mac backing you up on many loans. You also had some other securities buyers backing you up on other kinds of loans. Fannie Mae and Freddie Mac, I have always understood had certain qualifications, and you had to have a certain quality factor to your loan before they would purchase it in the secondary market, and maybe

some of these other companies were buying, you know, slightly crummier loans.

But my question is, what were the excesses that created this need in the first place, for a super-regulator?

Mr. ROBBINS. I think, first and foremost, the super-regulator was there to take a look at a host of different things.

The first one is the size of the portfolio. Does the size of the portfolio, and the leverage behind that portfolio, contain systemic risk, and if it does, does it need to be paired down to a size that meets market demand, but is not a portfolio used for investment purposes in order to inflate earnings?

Mr. PERLMUTTER. Was that more of an accounting issue, that they were inflating the—what was the problem there? How does this regulator now stop Fannie Mae or Freddie Mac from inflating their earnings?

Mr. ROBBINS. Because they have the ability to control the size of those portfolios by ordering them, as an example, as a bank regulator would do as they supervise a bank, order them to downsize the size of their portfolio, and to shed themselves of certain assets.

In other words, they would determine the size that portfolio would need to be, in order to meet its market demands and provide liquidity to the system.

Mr. PERLMUTTER. Okay.

Mr. ROBBINS. Number two, they would determine what their—whether they are holding true to their mission charter. That is, providing low- to moderate-income housing, and providing liquidity to a system.

They would determine whether they were operating within their secondary market charter, or they were moving more into the primary market, which—the concern then becomes they are—they enjoy certain benefits that would represent unfair competition, moving into a primary market, and essentially threatening organizations that operate within that area.

So, a big piece of this resolution would be control products, do those products represent safety and soundness concerns? Size of portfolio control, mission control, primary versus secondary market activities, monitor low-income housing goals. Are they realistic? In other words, it's important that they be goals that are obtainable at some point, without destroying the primary market.

Mr. PERLMUTTER. The bottom—

Mr. ROBBINS. Those kinds of issues.

Mr. PERLMUTTER. The bottom line being if they're going to get assistance from us, as the United States of America, they need to stay within their mission and not grow their portfolio just to be the biggest, you know, underwriter in the world, or whatever?

Mr. ROBBINS. And, ultimately, not present some kind of a systemic risk to the system, which is one that would affect the overall financial system—i.e., the name systemic behind it. In other words, if the GSEs were to implode for some reason, it could have a rippling effect through the entire economy.

Mr. PERLMUTTER. Do you think the bill that Chairman Frank filed on Friday, do you think it handles this key piece, you know, the excess of just growing too large, or trying to go into areas that thy weren't initially supposed to go into? Does it handle that?

Mr. ROBBINS. I think that the Mortgage Bankers Association is pleased with the bill, the way that it has been released.

Mr. PERLMUTTER. Now, I have—that was just sort of getting me on the same page with everybody.

I am sort of a child of the 1980's. When there was plenty of bank regulation and thrift regulation, and banks were failing, and thrifts were failing, and mortgage banks were failing, you know, so you can regulate like crazy sometimes, and still, the market turns on you. It might be a product that is bad, or it's just a bad time.

Is there discretion within—are we, in this legislation, setting down firm numbers, or are we giving the regulator plenty of discretion, and he is going to allow the individual Fannie Mae, Freddie Mac, Federal Home Loan Banks some discretion to develop or deal with their portfolios? Are we setting it down?

Because we had to change a lot of laws back in the 1980's to drop interest rates and things like that. Does my question make any sense? I mean, is there flexibility in this bill, or are we trying to legislate, instead of provide the regulator with some discretion, which then can allow the Fannie Mae, Freddie Mac, and the bank boards some discretion? Mr. Stevens?

Mr. STEVEN. Well, I think the bill—you know, again, it just came out Friday, so we're still looking at it. But I think, overall, from what we can gather, this bill does do just that. It doesn't over-regulate; it gives the regulator the authority to make the proper adjustments. I think that's what is key in keeping the housing market moving forward.

I think it does accomplish that, it doesn't over-regulate, and I would say that, you know, that is something that is a fine line, and we want to be cautious of it.

Mr. PERLMUTTER. And then, just as a follow-up, Mr. Menzies, I can tell you that with respect to the farm credit system, they—we should take care of this first, and then deal with that later, because they will fight like crazy to stay where they are, just having been interviewed by them on the campaign trail, so—

Mr. MENZIES. The chairman was perfectly clear about that.

Mr. PERLMUTTER. Okay.

Mr. MENZIES. Thank you.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

Chairman KANJORSKI. Mr. Murphy?

Mr. MURPHY. Thank you, Mr. Chairman. I wanted to return for just a moment to Mr. Lynch's line of questioning, so that maybe I can better understand the limitations of GSE reform, as it relates to the topic du jour of subprime lending. And maybe this is to the panel, but specifically to Ms. Petrou and Mr. Connelly, who both suggested that part of our response to the subprime lending issue is a world-class, or effective, regulator.

And given the fact that GSEs, as Ms. Petrou said, hold only about 25 percent of the subprime loans, only that top traunch that—are sent out into the market. Beyond that top level of subprime loans, what is the ability of GSE reform to really affect some of the issues happening at the origination of many of these subprime loans?

It just seems that maybe we do need to have a broader conversation about a more comprehensive regulatory system that takes into

consideration many of the excesses within the subprime market. I just am not seeing right now that GSE—or maybe I should ask the question. What are the limitations of reform of GSEs, in terms of some of the things we have been seeing within the subprime market?

Ms. PETROU. The limitation, I think, is that the GSEs are only a part of the market, and so that which is not theirs would not be affected by the GSE regulator.

But a good regulator looking at both credit risk and market risk, and ensuring that the GSEs meet their mission, which is not only to serve affordable housing, but also to support a liquid and, importantly, stable residential mortgage market, would make a great difference.

As has been said on this panel, mortgage brokers and many mortgage banks originate mortgages to sell. If they cannot sell them, they will not make them. If they cannot sell—if a mortgage secondary market purchaser looks at this and says, "Wait a minute. The income line on this mortgage is blank, this is a stated income loan yet this is"—I just was reading today a story about an 89-year-old home health care worker who refinanced her mortgage into a hybrid ARM, raising her mortgage payments from about $800 a month to $3,000 a month.

Now, that loan was originated and sold into the secondary market, because no one was looking carefully at its terms. A good regulator for the GSEs who says to them, "These are unsafe, unsound, predatory loans, you may not purchase them," would have a major impact on the market, as a whole, because if they can't sell them, they won't make them.

Mr. MURPHY. So, some of this is doing a better job of a regulator deciding what gets into the secondary market, rather than trying to influence origination?

Ms. PETROU. Yes, sir.

Mr. ROBBINS. The GSEs are not a regulator. They are an investor in mortgages. And the real answer, I mean, to the question that you have asked, is that the GSEs had no supervision over the subprime lenders, even remotely, because they originated a class of product that the GSEs were not purchasing, I mean, other than in an—out of the marketplace, in a AAA strip. So, they really fell under, if you will, the radar screen, relative to regulation in that respect.

Mr. MURPHY. Right. And I'm sorry if I misspoke. I certainly understand that the GSEs aren't regulators. But I guess that was the point of my question, is to make sure that we are not expecting this reform bill to have, you know, a major impact on the issue of subprime lending.

My second question is more to Mr. Menzies. You specifically raised a concern that GSE reform may have some impact on the ability of small, community banks to access that secondary market, and I would maybe just ask you to expand on that concern.

Because as someone new to this issue, the question how much a secondary mortgage holder may be able to keep in their portfolio versus how much they may be able to securitize doesn't strike me as a barrier to access from smaller banks. It merely is a question of how much the GSE may be able to hold, and how much they

may be able to send out for securitization. So, maybe just speak a little bit more on how portfolio standards are going to limit a small bank's ability to get into that market.

Mr. MENZIES. As Mr. Stern pointed out, when you contract the GSE, or reduce its portfolio, you reduce its income, you reduce its ability to have liquidity and flexibility, and the like.

It may well be that, by saying you can only have so much in portfolio, that you don't restrict access of community banks to the capital markets. But the reality is that the lion's share of portfolio loans are coming out of the larger institutions, not the smaller institutions, so, our concern would be that, however it goes down, we continue to have access to those markets, and that the bill doesn't unintentionally create an environment that supports the larger volume institutions and doesn't support the smaller volume institutions. If we do $103 million worth of loans over a 4- or 5-year period of time, that is somewhat beneath the drop in the bucket. It's really a very small amount of money.

So, it may be that, by restricting portfolio size, it doesn't reduce liquidity or access to the markets for community banks, but that certainly is our concern.

Mr. MURPHY. And is there anything beyond giving more flexibility on portfolio standards that we could do within this legislation to make sure that small lenders with very small pieces of the pie still have access to the secondary market?

Mr. MENZIES. Absolutely. We have lived, since the 1980's, when it all came apart, in a world of risk-based banking, and you can promulgate legislation and capital requirements that are truly risk-based, not just arbitrary, or some number.

I have lived in a risk-based world for the past 15 years, and it's worked quite nicely, thank you. I think that our regulators have done a great job of looking at our risks, at telling us what risks were acceptable, and telling us what risks were unacceptable, and there certainly would appear to be some risks that have gone into the GSEs that today, in hindsight, may be unacceptable risks. But risk-based capital should drive the capital requirements of the GSEs, I believe.

Mr. MURPHY. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you. We now have an opportunity to go to the other side of the aisle. And before I recognize Mr. Baker, may I say that his time spent on this issue over the last 7 years may be coming to a final, successful conclusion.

So, I welcome my good friend from Louisiana, who is a major contributor to this process now. Mr. Baker?

Mr. BAKER. I thank the gentleman for his kind words. Actually, I started causing trouble almost 15 years ago on this subject, and it's amazing to me that we are now talking, still, about a bill. But I know the gentleman's leadership will cross the finish line.

I wanted to return, just for a minute, for just a broad statement about the purpose of the underlying legislation, which is regulatory in nature, and to review the facts that for some time, the enterprises engaged in leveraging resources that were inherently guaranteed by the taxpayer for the charter purpose of facilitating first-time ownership opportunities for those otherwise not likely to get access to affordable credit.

On review of their practice, however, we found, over time, that their involvement in minority, women, first-time homebuyer participation not only did not lead the market, but in fact, trailed the market, and that the apparent utilization of the taxpayer guarantee was transferred over to the shareholder side, which enabled the enterprise, in good and bad financial markets, to make significant profit.

That, then, led some to question, "Where is the regulator in all of this? Shouldn't we get these folks focused on their mission? And is it the right use of a taxpayer guarantee to make shareholders double digit rates of return, when the rest of the market is going sideways?" The answer, generally, was, "Well, we at least ought to look at it." And I think, now, with the underlying bill, we have provided the regulator with some tools to make some of those judgements.

As to the problems of the existing portfolio and its distribution in the market, there is one very clear point that has always troubled me—and I don't believe it was mentioned here today—and that is among our insured financial institutions, for meeting their tier one capital requirements, about 70 percent or more of those institutions now meet those capital requirements by holding GSE securities. I was told by an FDIC person some time ago not to worry, that was really broad GSE debt. So I took great comfort in the fact that must have meant Farmer Mac. So I knew I wasn't worried, then.

Despite that fact, a significant amount of Fannie Mae and Freddie Mac debt are held by financial institutions as collateral for the day in which the bank has a difficult circumstance on its hand.

Secondly, when MBS was first developed and sold earlier, Freddie Mac and Fannie Mae representatives indicated they would not consider purchasing their own MBS, which now we know they do quite readily.

And one may argue that a large portfolio makes a great deal of sense if you're in the midst of a liquidity crisis, because the Chinese currency goes sideways. But the idea that several billion dollars of dollars of your own mortgage-backed securities are held in your own account does nothing but transfer the risk that was originally designed to be moved to the broader market; it is now brought back onto the books in order to yield the higher earnings that are provided by holding that MBS in portfolio. And it does nothing for housing—nothing.

And so, the debate over portfolio today, which a few years ago was repeal of the line of credit, which before that was some other issue, really is diversionary from the underlying purpose of the legislation, which is to have a gatekeeper worthy of its merit, standing between the activities of these enterprises, which are shareholder-owned, and business-driven institutions, and the guarantees of the United States taxpayer, which stands behind the hopefully unlikely, not to be expected sideways event which could occur at some point, therefore minimizing the scope of loss, with a regulatory shop of significant competency.

I believe that the bill now drafted and pending before the committee to be considered within the next week or so to be a good product, on the regulatory side. I don't know whether or not we

have gone quite far enough on the portfolio side, although I recognize that is somewhat of a managerial decision.

Since the enterprises were constructed to help get access for low-income individuals to housing, there should be some inherent risk involved in that portfolio, if they are facilitating product that enables that to occur. That's a balancing act, as against the shareholders, who are expecting financial reward for a well-managed company, and not to take unwarranted risk.

So, there is a managerial conflict we cannot preclude, nor should we try, I think, in a policy to step in between good management and shareholder resources, and tell them, "You simply cannot do this."

I think the bigger question, which hopefully will not be drawn into this discussion, is what constitutes inappropriate lending practices? What constitutes predatory? What is it that people are doing in the market that is not already a violation of Federal or State law, and let's get after that. That seems to be a much more difficult task in designing and coming up with the appropriate remedy.

But I do believe it is important for members of the committee to revisit the initial underlying issues for having the bill at all. The bill is needed to ensure that taxpayers are protected from hotshot management, and let me just say one quick word on that point.

There were 5 years of financials which enabled, because of hitting the earnings per share target, to the one-ten-thousandth of a cent accuracy—and I was told it was a statistical fluke, it just happened—that triggered $250 million in bonuses paid out to top executives over a 5-year period, on which there is now significant question as to if the financials were accurately accounted for. That, in itself, should be enough for this committee to act in a meaningful way.

But there are far more issues than just fudging the books and not providing the adequate incentives for individuals to get access to housing. And I believe the bill which the chairman has before the committee today is an excellent first start, and I hope we do not step aside from the principal goal.

And with that statement, I just wanted to ask, is there anything in the regulatory side of this bill that causes any of you at the table any discomfort? Anything we missed?

We hadn't talked, I don't think, much about portfolio regulation, but I believe putting that authority in the hands of the director, given the authority the new director will have, is quite sufficient. Anybody want to comment?

Mr. CONNELLY. Mr. Baker, America's Community Bankers thinks that the bill is a great start.

And I am delighted that you pointed out that for several years Fannie Mae and Freddie Mac haven't been able to produce financial statements. This clearly represents a huge internal control issue. What additional justification for better regulation is needed, when you think about it?

Mr. BAKER. Well, my comment would be if any other public company had a multi-year, multi-billion dollar misstatement of financials, and could not certify their accounting, I don't know how they would effectively survive on Wall Street, going into year six. But that only points out, I think, the belief that many have in the mar-

ket that the U.S. Government will stand in and do what's necessary, in the event bad things happen. And that's what we have to fix. Anything else?

Mr. STERN. Mr. Baker, just to respond to different sides, you know one part of the mortgage industry a lot better than I do. And I know the origination side very well. And just a view from what's going on in the market, for a second. You had talked about the role of the GSEs, and their effectiveness in creating—in providing low to moderate-income housing, and their success in their mission.

The reality of the recent marketplace is borrowers had choices. You could have a GSE loan with 5 percent down, or a private loan with zero percent down. Well, what do you think the borrowers took? They took the zero percent down. They could have a loan with full pay stubs and bank statements and tax returns, or they could have a loan with no pay stubs and bank statements and tax returns? Well, what do you think the borrowers took? No pay stubs, no bank statements.

So, the GSEs market share was affected not because they lowered their standards, or because they weren't doing their mission, but because products existed that said to the borrower, "You don't need a downpayment, you don't need tax returns, you don't need bank statements." And look what happened.

It was not the GSEs and—but—and their performance, and their achievement of their mission where the problem has been. In fact, I would say if there was anything that the GSEs have done incredibly well, it is the products they put into the marketplace, and the regulations they have which give us suitability and uniformity with investors across the world. But we are going to go through a correction in the private marketplace, the unregulated marketplace. But if anything, it is not the GSEs, and their area of product.

We do applaud the efforts of a strong, world-class bank-like regulator, for purposes of things like their accounting. But, if anything, I think that the GSEs are doing well. It is their products and the role they are playing in the market, in that regard.

Mr. BAKER. If I will—my time has long since expired, and just with the deference with the chairman, I have some differences with the statement in that I do believe that when you look at the number of mortgages held in portfolio by the GSEs over time, you will find them to be less than 2 percent, in most cases, of the kinds of individuals that they should be helping. And you will find that, in most cases, the average housing cost is somewhere north of $200,000, with 2 working incomes, the dog, the cat, the Chevrolet, and the Ford.

It is middle America that makes up Fannie Mae's portfolio, and that's where they make their money. And the mismatch which caused the trouble was internal managerial fluffing to get the numbers where they needed to be to make themselves look right, and that's what caused the ultimate demise. It wasn't a market failure, it was a managerial failure that got them to this point in time.

Chairman KANJORSKI. Thank you, Mr. Baker. Finally, Mr. Price?

Mr. PRICE. Mr. Chairman, I can't speak to Fannie Mae or Freddie Mac, but Mr. Baker, before you came in, there was some discussion about the public independent directors. And in response

to your question, let me raise one thing for the consideration of the committee.

Our bank, like all the other Home Loan Banks, has been very seriously taking its responsibilities to find appropriate skill sets—that were alluded to earlier by panelists here—for members of the boards to be appointed or selected as the independent directors.

One thing we are finding, even looking at non-establishment figures, Mr. Chairman, is that many of the people whom we had short-listed as having competencies in either rehabilitation housing, home building, community development, public finance, derivatives in complex financial instruments, audit and accounting, we are finding that the bulk—more than 60 percent of the folks that we had first thought might make great directors—are disqualified, because the statute evidently says that no person may serve as a public independent director who owns one share of any member institution of the Home Loan Bank in that geography.

So, if you had a community development person, an executive director of a local community development authority, who happened to own a share of stock in Sovereign Bank in Pennsylvania, or a community bank, or Citibank, which is one of our customers through Delaware, they would be disqualified to serve.

So, I simply put that in front of the committee for consideration as part of this legislation. Thank you.

Chairman KANJORSKI. Thank you, Mr. Price. And now, finally, the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. I thank you, Chairman Kanjorski, and I thank all the panelists today. And first, I want to congratulate Chairman Frank, and really, Congressman Baker, for their introduction of the GSE reform bill, and compliment Mr. Baker for his long-standing leadership.

I think this is a strong and balanced bill, which builds on the bill we passed last year, and I also want to compliment Chairman Kanjorski's work with Treasury. I fully support it.

When I first came to Congress, the very first bill I voted on—the one that I remember—was the bail-out of the S&Ls, the savings and loans, to the tune of billions of dollars. It was a tough thing for a freshman who won by less than 1 percent to vote on, but I voted on it, and we bailed them out. But still, I believe strongly in strict regulation and strong attention to safety and soundness.

And I am particularly concerned with the safety and soundness provisions in this bill, the capital, new product review, and portfolio proportions that the witnesses commented on. I would like to build on the questions of Mr. Lynch, Mr. Perlmutter, and Mr. Murphy, and ask Ms. Petrou, all—happy St. Patrick's Day, by the way, Mr. Murphy—by the way, I wanted to ask Ms. Petrou about the closely related safety and soundness issue, which is the GSEs' involvement in the subprime market, and their exposure to the crisis that is going on in the market right now.

Freddie Mac announced that they will no longer buy subprime hybrid mortgage loans, and they basically said that they would follow the guidance that came out from some of the regulators, that they would—you should no longer issue loans that the consumer cannot pay for.

And I would like to ask Ms. Petrou if you believe that the other GSEs should follow Freddie Mac's leadership in basically saying that they will adhere and follow the new guidance. As you so eloquently said earlier in response to Mr. Murphy, if you don't buy the product, they're not going to make the product.

And as was pointed out by the gentleman recently, Mr. Stern, you were saying they are selling loans where you don't have to show your income, you don't have to show any record of making your sales, of being loyal—your creditworthiness. So, if you don't have any creditworthiness, should we be surprised that there appears to be a crisis in the market?

I, too, read the article that Ms. Petrou talked about. It was on the cover of the Wall Street Journal. I would like to put it in the record, with unanimous consent, where basically, a woman had an $800 a month loan, and she is older and confused, and they ended up selling her a $4,000 a month loan, which she could not afford, and she is in the process of losing her house.

So, I would like to hear your comments, and anyone else's comments, on having the GSEs follow the guidance that has come out from the regulators, which Freddie Mac has voluntarily adhered to.

Ms. PETROU. Thank you. I think it is a very good thing that Freddie Mac has made this statement about hybrid ARMs, and the qualifications it will look to, that the banking agencies Friday a week ago came out with standards, and OFHEO a while ago asked Fannie Mae and Freddie Mac to comply with the guidance issue last year on traditional mortgages, and one would expect that it would likely do the same, once the banking agencies finalize the subprime guidance.

But what really concerns me is not so much looking forward, but looking at where we are now, and saying, "Oh, heavens, I just won't buy any more hybrid ARMs, you know, with stated income, and all of these other criteria." Well, what about the borrowers who are in them now, and the risks which were palpable and obvious then?

And I think that speaks to the urgent need for good regulation, because we have a lot of hurting homeowners out there. And forward-looking reform is critical, but we also need to think through why we are where we are, both from the borrower and the lender and the GSE point of view, because it is a very distressing picture at this point.

Mrs. MALONEY. Well, following up on your statement, why do you think we are where we are?

Ms. PETROU. There was another very good article in the New York Times on Sunday by Ben Stein, who said that too many teenagers were running things. I think I'm up in age now where I agree with that.

People forgot that subprime is higher-risk. Higher risk means more losses. Lack of documentation invites fraud. Lack of risk-based capital—Mr. Menzies is very right about that. The OFHEO risk-based capital rule now does not capture credit risk. It is ratings-based.

This was an issue built in by Congress when you enacted the 1992 Act without the ability—which, of course, could not have been done—but by hard-wiring the GSE capital rules in 1992, they do

not capture market realities now, and they do permit a tremendous amount of gamesmanship, regulatory capital, arbitrage, and perhaps creating undue market incentives for inappropriate risk taking.

Mrs. MALONEY. I would say that in the past it was very uncomplicated. I grew up in a small town, and our neighborhood community banker knew everyone. He knew their credit depth. He knew everything about them, and he didn't give out loans that they couldn't pay back.

And to what extent do you think the increase in loan originators, entities offering homeowners mortgages made possible by the huge growth of the GSEs, how much do you think these sort of new loan originators have contributed to the present subprime problem, and what can we do about it through GSE regulation?

We certainly want to expand available credit, but expanding credit is really, in some cases, in conflict with safety and soundness. Have we gone too far in allowing so many entities to get involved? I invite anyone on the panel to respond.

Mr. MENZIES. If I could speak as a community banker, we do know most of our customers on a personal basis. And we do write subprime loans, but we don't put them in the secondary market.

We may do 100 loan to value loans, as a community bank, and Daddy will guarantee 20 percent, and the kids will do 80 percent, and we will put it on our books, and after 3 or 4 years, when the double income has grown up, then it goes into the secondary market. And we do that on a regular basis.

ICBA Mortgage Corporation generated about an $800 million or $900 million mortgage portfolio with RMS, our servicing vendor, over about a 6-year or 7-year period of time. And that mortgage portfolio that came strictly from community banks was the best performing portfolio in the entire $30 billion RMS portfolio.

Community banks generally write the 30-year, 15-year, fixed-rate, plain vanilla ordinary loan, and don't generally get into the subprime type credits. So, my answer would be to appoint a strong regulator, and make that strong regulator do risk-based capital allocations, the same way I do. If I write a loan, and the FDIC comes in and they look at it, and they say, "We don't like that loan," then I have to appropriate more in reserves. And they grade my risks, based on the risks that we take. And we set aside reserves, based on the risks that we take.

So, my perspective would be risk-based capital, and a strong regulator.

Mrs. MALONEY. To some extent, the affordable housing goals set for the GSEs, our intention with any tightening of credit, no matter how necessary, and is there enough guidance and authority in this bill to allow the new regulator to properly shape that balance? Anyone?

Ms. PETROU. I would say that the new bill, as I quickly read it over the weekend, contains language that does, first of all, I think aligns the GSE affordable housing goals better with those applicable to banks under the Community Reinvestment Act, so that the definitions of low and moderate income are more appropriate. I think that will help serve the market better.

But the regulator does have the authority to review those goals, and reset them, if safety and soundness concerns are presented. Right now, that is not possible, because the goals are solely under the guidance of HUD, and HUD is not a safety and soundness regulator. So that balance, under current law, does not properly exist.

Mrs. MALONEY. Do you think we should write legislation that would apply the guidance rule that Freddie Mac is now following, do you think we should legislate it so that all housing GSEs must follow it? Would that bring more safety and soundness to the markets?

Mr. ROBBINS. It—I would argue—well, number one, Freddie Mac said that they would continue to buy hybrid loans, but only ones that were underwritten at the fully indexed rate.

Mrs. MALONEY. Right.

Mr. ROBBINS. The problem with underwriting loans at the fully indexed rate is that it will literally take away the opportunity for thousands of homeowners to purchase homes. I went through some statistics earlier that are in the record for your observation, and I want to go over them again and take—but one of the things that we need to separate in our minds is the difference between loan products that were used to help homeowners get in homes and predatory loans. They are two different types of issues.

Predatory loans—the 80-year-old, or 85-year-old lady—are unconscionable, and everybody in the industry wants to see the perpetrators of those kinds of loans dealt with.

The products that help homeowners get into homes are the issue, and we would argue that loan products, whether they are 228s or negatively amortized, or interest only, used properly, are extremely valuable in getting homeownership to near-record levels, where it is, especially with minority Americans, and would argue that it would be improper to put undue restrictions on loan products, other than dealing with the people who use them improperly.

Mrs. MALONEY. But, basically, the guidance, as I read it, said you don't give a loan to someone who can't pay for it. And I think that makes common sense, that we don't give a loan to someone who can't pay for it.

Mr. ROBBINS. We—

Mrs. MALONEY. In other words, if you have a law student who is going to be paid a lot of money next year, they can take the hybrid loan. But if you have an 85-year-old woman on a fixed income, you don't sell her a loan that she can't pay.

To me, it seemed like good guidance that made common sense, and—

Mr. ROBBINS. We at the Mortgage Bankers Association absolutely agree with you. I can tell you, from personal experience—I have been in the mortgage banking business for 36 years—a foreclosure costs us $40,000. And so, our economic interests are 100 percent aligned with the borrowers in this case.

And as I had mentioned earlier, there were some aggressive players in the industry who wanted to grow market share. They did sell through very aggressive underwriting, and are paying the price for that today. And so, underwriting a loan, and providing that instrument to people who you think have the capacity to repay that loan, are still imperative within this industry.

Mrs. MALONEY. Well, my time is up. I thank the chairman for this hearing, and all of the panelists for testifying.

Chairman KANJORSKI. Thank you. Just an observation on your question, if you can't get a loan if you can't pay for it, it seems to me that the U.S. Government should have a tough time getting a loan.

[Laughter]

Chairman KANJORSKI. Having made that observation, I do want to ask one other question, something that is the jurisdiction of this subcommittee—insurance.

Has anyone done an analysis of the credit problems in the subprime lending market, and its draw on mortgage insurance, whether or not that will risk the mortgage insurance firms, and therefore, expand the risk to otherwise good paper in the marketplace?

Ms. PETROU. Mortgage insurance firms generally do not provide coverage on subprime mortgages. Their focus is on the prime market. So, the immediate concern for the private mortgage insurance industry is not significant.

However, there is considerable concern for the Federal Housing Administration, because the FHA and the Federal Government do back many loans which might be, by virtue of the risk of the borrower, considered to be subprime.

Chairman KANJORSKI. Very good.

Mr. STERN. Just to reinforce, we do a limited amount of subprime loans, but to concur, those ones typically do not need private mortgage insurance, so the subprime loans are not a drain on the mortgage insurance market.

Chairman KANJORSKI. Very good. Thank you. Mr. Baker, do you have any other questions?

Mr. BAKER. I just want to thank you for your leadership on this, and I look forward to working with you, Mr. Chairman.

Chairman KANJORSKI. Mr. Garrett, I want to thank all the members that were here. This is a tough day to have a hearing, a Monday, when they are in travel.

I particularly want to take this opportunity to thank the panel, and make an observation, because so much of the panel is involved with community banking, either directly or indirectly. Although I don't necessarily have the most famous reputation in town as an advocate of community banking, I want to disgorge that thought process.

In reality, I am interested in the proper operation of the Federal Home Loan Bank system, and the success of Freddie Mac and Fannie Mae. It is primarily because I am acutely aware, coming from Pennsylvania, of how intricately involved and successful the community banks are in providing for an area that otherwise would not be provided for, if we had to rely on the huge institutions of this country.

So, the fact that so many of you have connections, interests, or represent the community banks, I want to thank you for your testimony. We certainly want to take that into consideration. This is obviously not a credit union bill, this is a community bank bill, and we are going to protect the community banks in this instance, as

we would the credit unions, if they had an issue here. So, thank you very much. I appreciate your attendance.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses, and to place their responses in the record. This hearing is adjourned.

[Whereupon, at 4:18 p.m., the hearing was adjourned.]

A P P E N D I X

March 12, 2007

OPENING STATEMENT
GSE REFORM
CAPITAL MARKETS SUBCOMMITTEE
RANKING MEMBER SPENCER BACHUS
Monday, March 12, 2007

Thank you, Chairman Kanjorski, for holding this important hearing today on a frequently overlooked component of GSE reform: the Federal Home Loan Bank System.

This system of cooperatively owned institutions was established during the Great Depression to help facilitate liquidity for the extension of credit for the purchase of homes by individuals. Today, the bank system is composed of 12 separate districts with nearly 8,000 members and is enjoying a growth in its programmatic and financial activities as a result of several legislative changes through the years, most recently in the Gramm-Leach-Bliley Act of 1999.

Federal Home Loan Banks help create a liquid residential mortgage market, but they also promote small business financing and supply funds for affordable housing and community investment.

In light of these important responsibilities, Congress has the duty to ensure the safety and soundness of the Home Loan Bank System and to monitor whether the Banks appropriately satisfy their missions. As these institutions' financing and risk management strategies have become more complex in recent years, the need for vigilant congressional oversight has only increased.

Sound corporate governance is critical to the functioning of any enterprise. The arguments to include the Home Loan Banks in a better, stronger regulatory framework are consistent with the arguments to include Fannie Mae and Freddie

Mac. In my view, the benefits of better regulation will accrue not only to the taxpayer and financial system at-large but also to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Also, I understand that the Subcommittee Chairman has a long-standing interest in the issue of public interest board membership for these public-private institutions. I have been concerned that the Banks have not been operating with full boards of directors. However, I want to commend the Federal Housing Finance Board and its Chairman, Mr. Rosenfeld, for responding to this problem and issuing a sensible interim rule to fill these seats. The Finance Board is authorized to appoint public interest directors to the Banks' boards and it is my view that its proposed procedures will enhance its ability to appoint well-qualified individuals.

Homeownership is available today to more Americans than ever before, and further promoting homeownership – increasing access to the American Dream -- is a priority of the Republican members of this Committee. It is time to strengthen the GSEs' safety and soundness regulator, to ensure the regulator has the resources to do its job effectively and to ensure that America's system of housing finance is secure. By passing meaningful legislation, we can achieve these goals.

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON LEGISLATIVE PROPOSALS ON GOVERNMENT SPONSORED ENTERPRISE REFORM

MONDAY, MARCH 12, 2007

We meet this afternoon to examine once again how best to regulate the housing government sponsored enterprises, or GSEs. The debates on GSE regulatory reform began 7 years ago this month in 2000 when we held a hearing on H.R. 3703, the Housing Finance Regulatory Improvement Act.

In every session of Congress since then, the House has had at least one regulatory reform bill under consideration. The Financial Services Committee has also held dozens of hearings on these matters over the years, and we have heard from scores of witnesses. These hearings, as well as external events like the financial reporting problems at the GSEs, have led us to develop a growing consensus on GSE regulatory reform.

In the last Congress, we considered H.R. 1461, the Federal Housing Finance Reform Act, on the House floor and approved it by a vote of 330 to 91. Because that bill did not become law, we are returning to these important matters today.

The housing GSEs play vitally important roles in our nation's housing finance system. Fannie Mae and Freddie Mac presently guarantee about $3 trillion in mortgage-backed securities. The Federal Home Loan Banks also have more than 8,100 members, possess in excess of $1 trillion in assets, and hold about $100 billion in mortgage loans.

As I have long said, we need to have strong, independent, and world-class GSE regulation to oversee these sizable institutions. Such a regulatory system will promote confidence in the GSEs, protect the continued viability of our capital markets, insure taxpayers against systemic risk, and expand housing opportunities.

An appropriate regulatory system, like the bill we passed in the 109th Congress, should adhere to several key principles. For example, the regulator must have a funding stream separate and apart from the annual appropriations process.

In order be credible and effective, the regulator must additionally have genuine independence from the political system. Such independence must consist of complete autonomy from the enterprises, include sufficient protection from outside special interests, and provide substantial insulation from political interference.

A strong regulator must further have robust supervisory and enforcement powers. In this regard, many have suggested that we should model GSE safety-and-soundness regulation on that of other financial institutions. I agree with this sensible concept.

In fact, the general goal of our long-standing regulatory reform debates has been to make GSE supervision more bank-like. Any safety-and-soundness regulator for the housing GSEs needs to have enforcement powers on par with other federal banking regulators.

As we proceed in the coming weeks, I also hope that we all will continue to remember why we created these public-private entities. We created GSEs to help make credit available to finance home purchases, because the private market was not effectively meeting credit needs.

Beyond ensuring that the GSEs can continue to fulfill their missions, we must maintain a public voice on their boards. Public participation on these boards helps to focus the GSEs on their missions.

Beyond working to improve GSE regulatory oversight, we should also look at the upcoming legislative debates as an opportunity to update the statutory mission of the Federal Home Loan Bank System to reflect what it actually now does. In 1999, I worked with then-Chairman Baker to allow the Federal Home Loan Banks to provide liquidity to community financial institutions for the purposes of serving small farm, small business, and small agri-business customers.

In its bill in the last Congress, the Senate Banking Committee had language that would have explicitly added such economic development activities to the mission of the Federal Home Loan Banks. This idea has merit, and we ought to consider it in this chamber.

Before I close, I would be remiss if I failed to welcome Deborah Pryce as the Capital Markets Subcommittee's most senior Republican. I look forward to working with her in the 110th Congress to reach a bipartisan consensus on the matters under our jurisdiction.

In sum, in developing any enhanced GSE regulatory system, we should perform deliberate surgery. We should abstain from considering radical proposals that would undermine their charters. We also should take appropriate steps to improve their mission and performance, in addition to providing for strong, independent and world-class GSE regulation.

Written Testimony of

America's Community Bankers

on

"Legislative Proposals on GSE Reform"

before the

Capital Markets, Insurance and
Government Sponsored Enterprises Subcommittee

of the

Committee on Financial Services

of the

U.S. House of Representatives

on

March 12, 2007

Arthur R. Connelly
First Vice Chairman
America's Community Bankers

Chairman & CEO
South Shore Bancorp MHC
Weymouth, Massachusetts

Good Morning Chairman Kanjorski, Ranking Member Pryce, and members of the Subcommittee. My name is Arthur Connelly and I am the Chairman and CEO of South Shore Bancorp, MHC. South Shore Savings Bank is a wholly owned subsidiary of South Shore Bancorp, MHC. I serve on the board of the Federal Home Loan Bank of Boston, and South Shore Savings Bank is a seller/servicer for Fannie Mae and Freddie Mac. I am also the First Vice Chairman of America's Community Bankers ("ACB"), and I am testifying today on their behalf, and not in my capacity as a board member of the FHLBank of Boston. ACB's members originate 1 in 4 mortgages in the Unites States. South Shore is a $915 million community bank in Weymouth, Massachusetts and our primary business is originating mortgages for families.

ACB was among the first to call for reform of the regulatory structure for Fannie Mae and Freddie Mac, and later was the first to call for consolidation of regulation of the Federal Home Loan Bank System regulation into a new regulator for Government Sponsored Enterprises (GSEs). ACB strongly supports legislation that meets the following essential criteria.

- **The new regulator must be independent.**
  It is critical that a new world-class regulator for GSEs have the authority to conduct necessary supervision, regulation and budgeting for the GSEs independently from the Administration and the Congressional appropriations process.

- **The regulator must possess authority to clearly distinguish permissible secondary from impermissible primary market activities at Fannie Mae and Freddie Mac.**

- **Portfolio and capital authority must be adequate.**
  The regulator must have regulatory and supervisory authorities' equivalent to that of the federal banking regulators, including authority to adjust portfolio holdings and capital requirements – for safety and soundness concerns.

- **The unique cooperative structure of the FHLBanks must be preserved.**
  Regulation of the FHLBank System can be improved within the framework of a single consolidated GSE regulator, but only if adequate safeguards are provided to recognize and maintain the unique cooperative characteristics of the System.

ACB strongly supported the Federal Housing Finance Reform Act of 2005, which overwhelmingly passed the U.S. House of Representatives in the 109th Congress, and strongly supports passage of similar legislation in the 110th Congress.

Regulation of Fannie Mae and Freddie Mac

Throughout the debate on GSE regulatory reform, ACB has maintained that Fannie Mae and Freddie Mac need a new regulator with world-class regulatory powers modeled on those which Congress has established for the banking agencies. That is why we strongly supported H.R. 1461 in the 109th Congress and urged its passage. As the recent accounting and management scandals at Fannie Mae and Freddie Mac have demonstrated these institutions are too important to our national housing policy, financial markets and the economy as a whole to neglect with

inadequate supervision and regulation. Thankfully, these GSEs, if not out of the woods, are well on the way to better management and recovery. But, we have dodged the bullet, and may not be so lucky next time. Now is the time to preserve all that these important institutions can offer by providing for the regulatory structure that they warrant.

When we say a "world-class regulator," we mean that a new GSE regulator must have certain authorities to ensure that Fannie Mae and Freddie Mac operate in a manner that is both safe and sound, consistent with their mission and within the purview of their charters. We believe that the powers of a "world-class regulator" include:

- The regulator must possess similar supervision and enforcement powers to those of federal banking agencies to maintain safety and soundness and guard against systemic risk,[1] and to insure compliance with all applicable laws.
- The regulator must have the resources and expertise to evaluate Fannie Mae's and Freddie Mac's performance, both as financially sound entities and as public purpose entities. The regulator should not be subject to the Congressional appropriations process.
- Capital requirements established for Fannie Mae and Freddie Mac should reflect the specific financial risks facing each, including realistic treatment of counter party risk. Freddie Mac's and Fannie Mae's capital requirements should be consistent with the capital requirements imposed on other federally regulated entities with similar risk profiles.
- The regulator should have authority to adjust all capital requirements for safety and soundness concerns.
- The regulator should establish appropriate housing goals for the enterprises.
- Congress should not directly govern portfolio holdings of Fannie Mae and Freddie Mac. However, in order to manage safety and soundness and systemic risk concerns, the regulator should have authority to adjust Fannie Mae and Freddie Mac's portfolio holdings.

In addition to granting these authorities to the new regulator, ACB supports increased transparency and disclosure for Fannie Mae's and Freddie Mac's debt, equity and mortgage-backed securities. We believe that their disclosure should generally meet the standards applied by the SEC to public companies that issue securities. Fannie Mae and Freddie Mac issue publicly traded shares, and investors who purchase their stock have the right to the same level of disclosure from the GSEs as from any other publicly listed company.

However, ACB opposes any attempt to eliminate Fannie Mae and Freddie Mac's exemption from having to register under the Securities Act of 1933. Both companies have agreed to meet the disclosures of the 1934 Securities and Exchange Act, which will provide SEC-regulated

---

1 Several financial regulators define systemic risk. For instance, the joint interagency statement issued by the FRB, OCC and SEC on April 8, 2003 states: Systemic risk includes the risk that the failure of one participant in a transfer system or financial market to meet its required obligations will cause other participants to be unable to meet their obligations when due, causing significant liquidity or credit problems or threatening the stability of financial markets.

annual and quarterly disclosures for investors. Given the volume of debt issued by Fannie Mae and Freddie Mac, removing the exemption from the 1933 Act could prove unnecessarily costly and burdensome, and would not materially improve those disclosures essential to the investing public. ACB also opposes proposals to revoke or limit Fannie Mae and Freddie Mac's existing line of credit at the Department of the Treasury.

Secondary Market Role of Fannie Mae and Freddie Mac

ACB also believes that GSE reform legislation must reemphasize the secondary market nature of Fannie Mae and Freddie Mac's assigned role in the housing finance arena. ACB supports policies that explicitly prevent using the benefits of Fannie Mae and Freddie Mac's quasi-government agency status to engage in primary market activities, including eliminating or discouraging competition among private sector participants in the mortgage lending, servicing and ancillary markets. ACB believes that meaningful reform legislation should specifically outline that Fannie Mae and Freddie Mac must stay in the secondary market, and it must permit the new regulator to strictly prevent them from entering the primary market. In this regard, ACB urges the Committee to adopt language similar to that included in section 122 of H.R. 1461, which established that the Director "consider the definitions of the terms 'mortgage loan origination' and 'secondary mortgage market'."

Models for Affordable Housing Programs

ACB has not spoken out previously on the issue of affordable housing funds for secondary market housing GSEs, but we feel it is time to do so because of the unique and pioneering experience we have had with such funds. In 1989 AHP obligations were established for the FHLBanks. Since that time, ACB members continuously have held the majority of FHLBank System stock, and as a consequence have had the primary ownership interest in the operation of the programs. These AHP programs have been a model for success as a means of satisfying mission requirements reasonably expected in return for the GSE advantages conferred by Congress.

The success of the FHLBank AHP operations suggests certain characteristics that should be fostered in similar programs that are proposed for other GSEs. In particular, FHLBank AHPs most often engage the private sector in identification, funding or management of affordable housing projects using various partnerships. These partnerships uniquely combine private efficiency and management with attention to the greatest unmet community and social needs. ACB strongly recommends that any newly established AHPs draw heavily from the AHP experiences at the FHLBanks, especially the design to include private sector lenders and developers in all phases of the project development and management process.

Importance of the FHLBank System

As a community banker, I truly appreciate the critical role that GSEs play in providing community banks with the liquidity to keep us competitive with larger institutions. In my case, that is especially true of the FHLBank System.

South Shore Savings Bank is a member of the Federal Home Loan Bank of Boston and has average annual advances of between $175-180 million. That's roughly 22 percent of our liabilities. We could not offer the mortgage products we do if we did not have access to FHLBank advances. We rely on the FHLBank System day in and day out to help us conduct our mortgage lending business in a safe and sound manner.

As an indication of the importance of the FHLBank System to the liquidity and funding of community banks, a recent study by ACB indicated that advances comprised 21 percent of the liabilities for member banks active in the System.[2] Further, in the recent Survey of Community Bank Executives conducted by Grant Thornton, 73 percent of the respondents reported that they used FHLBank advances as a source of funding in 2006 and 27 percent expected to increase their use in 2007, while 34% expected usage to be the same as last year.[3] The survey also noted that finding adequate funding sources to support community lending was important for 77% of the respondents, but only 57% were confident that adequate funding would be available. These numbers confirm the importance of the FHLBank System to a broad base of community banks and are an indication of the evolution of the System in the past 17 years.

Community banks have a recognized history of superior performance in lending to low income and minority borrowers. Studies reported by the Federal Reserve have shown that "depository institutions have higher portfolio and market shares than the two for-profit government-sponsored enterprises that are active in the secondary market, the Federal National Mortgage Association ('Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac")."[4] The FHLBanks support this business with advances and a variety of programs, including the Affordable Housing Program ("AHP"). As noted, the FHLBank AHPs are excellent models of how GSEs can better support the urgent need to add to our nation's stock of affordable housing, especially where a directed subsidy is necessary to attain the goal. Community banks also have a strong record of lending to first time homebuyers. In 2004, according to a survey conducted by ACB, respondents reported that 12 percent of mortgage loans were made to first time home buyers.[5] These activities would not have been possible without the access to advances and the local programs that are made possible because of the FHLBanks.

The System's structure has evolved over time and continues to provide a much needed source of funds for the majority of its member institutions. Advances make it possible for community banks to make sound home loans that may not conform to the strict criteria of the secondary market. FHLBank advances also provide an important alternative funding source for community

---

[2] *Washington e-Perspective*, America's Community Bankers, March 9, 2005
[3] *Twelfth Annual Survey of Community Bank Executives*, Grant Thornton, March 2006
[4] Volume 82, *Federal Reserve Bulletin* Number 12: page 1077
[5] *2005 Real Estate Lending Survey*, America's Community Bankers, February 2005

banks that choose to keep loans they originate – whether conforming or not – in their own portfolios. Community banks rely on the advance window for funding particularly in this difficult environment where other funding sources often are not readily available.

As the debate progresses and Congress considers the concerns common to the FHLBank System and the secondary market GSEs, I urge you to ensure that the legislation provides a new regulatory structure that recognizes the unique and successful business model of the FHLBank System. Unlike Fannie Mae and Freddie Mac, which are publicly held companies, the System is a cooperative owned by its member institutions and each of the FHLBanks is jointly and severally liable to all the others. Both of these GSE business models have their strengths. Any revised regulatory system should continue to respect those differences, while advancing the common goal – to maintain their financial safety and soundness.

Regulation of the FHLBank System

The FHLBank System was established in 1932 as a source of liquidity for savings and loan associations - the primary home mortgage lenders in America. These institutions were required to be members of the individual FHLBank in their regions and were required to collateralize the advances with home mortgage loans. At the time, these institutions were generally unable to obtain funding by any other means than deposit gathering. Without the System providing advances at reasonable cost to these institutions, millions of Americans would not have been able to become homeowners.

Even with the creation and expansion of the secondary market for mortgage loans, many lenders today would not be able to serve their customers without funding from the FHLBanks. This is evident in the continual reliance on advances funding by member institutions. The loans these lenders make are frequently non-conforming or may be part of a targeted lending program. Community banks may also choose not to sell all of their loans to the secondary market because they prefer to maintain customer contact and service.

In 1989, as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the System membership was opened up to commercial banks and credit unions. Today the System includes 12 FHLBanks with over 8,000 members. The operations of the individual FHLBanks were separated from the supervisory functions that they had provided since 1932, and the current regulator, the Federal Housing Finance Board ("FHFB"), was created. In 1999, the System changed again with the imposition of new capital requirements and expanded collateral options.

While the FHFB has evolved as a regulator and placed a greater emphasis on the safe and sound operation of the FHLBanks and on supervision of the System, it still is subject to limited resources. The legislation must strengthen the regulator and provide a greater depth of resources and expertise.

The Rationale for Change

The rationale for including the FHLBanks and the FHFB in GSE Regulatory Reform is much

different than for the secondary market housing GSEs. First, financial problems and adjustments to uniform accounting standards under SEC guidance have been much less significant. Second, the FHFB operates under statutory guidance that provides strong regulatory authority and mission oversight consistent with what would be expected for a world class regulator, and substantially similar to statutory authorities provided to the banking agencies. Therefore, the first objective of any statutory change affecting FHLB System is to do no harm. This objective was reflected in H.R. 1461, and again in this year's discussion draft, by the fact that only a small portion of legislative proposals have addressed System issues. Improvements in regulation are expected primarily from synergies and expertise that should be available in a new regulatory structure. Substantive areas in which there may be synergies include interest rate risk management and accounting guidance.

Authority to Regulate the Capital Requirements of the FHLBanks

The FHFB's authority to regulate the capital requirements of the FHLBanks is both explicitly and implicitly provided for in the FHLB Act. The FHLB Act explicitly provides that, the FHFB must issue regulations prescribing uniform capital standards applicable to each FHLBank. These standards must require each FHLBank to meet the minimum leverage and risk-based capital requirements specified in the FHLB Act. The leverage requirement requires each FHLBank to maintain a minimum capital of five percent of assets.[6] Further, each FHLBank must maintain permanent capital in an amount that is sufficient, as determined in accordance with FHFB regulations, to meet the credit risk and market risk, including interest rate risk, to which each FHLBank is subject based on a "stress" test established by the FHFB that "rigorously tests for changes in market variables, including changes in interest rates, rate volatility and changes in the shape of yield curve."[7] Finally, the FHFB, in establishing the foregoing risk-based standards, is required to take "due consideration" of any risk-based capital test established by the OFHEO. The FHFB's implicit authority to regulate the capital requirements of the FHLBanks derives from its general duties and powers under the FHLB Act to insure safe and sound operation.

Authority to Establish the Type and Scope of Activities Permissible for the FHLBanks

The FHFB's authority to regulate the type and scope of permissible activities of the FHLBanks is expressly authorized under the FHLB Act with respect to specified activities of the FHLBanks, where such statutory authority is not expressly authorized, the FHFB has taken the position that the authority to authorize activities by FHLBanks is implied pursuant to its general duties and powers under Section 1422b of the FHLB Act.

---

[6] 12 U.S.C. § 1426(a)(2)(A). In determining compliance with the minimum leverage ratio, the paid-in value of outstanding FHLBank Class B Stock and retained earnings, both based on a 1.5 multiplier, are deemed capital for purposes of meeting the 5 percent minimum leverage ratio, except that a FHLBank's total capital (determined without taking into account the 1.5 multiplier) may not be less than 4 percent of a FHLBank's total assets. 12 U.S.C. § 1426(a)(2)(B).

[7] 12 U.S.C. § 1426(a)(3)(A) the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, with such modifications as the FHFB determines to be appropriate to reflect differences in operations between the FHLBanks and those enterprises. 12 U.S.C. § 4611. 12 U.S.C. § 1426(a)(3)(B).

The Future of the System

Because of the strength of the regulatory structure, there is minimal need to alter the statutory frame work for the FHLB System. The primary reasons for change are to provide a broader and deeper scale under which to carry out the statutory mandate and to improve the process for choosing member, independent and public interest directors on the boards of the FHLBanks. Also, any legislation should reflect the differences between the Federal Home Loan Bank System and Fannie Mae and Freddie Mac.

As the debate over the appropriate regulatory scheme for the GSEs develops, I cannot stress strongly enough the importance of preserving and maintaining the cooperative nature of the FHLBank System under a new structure of regulation and supervision of the System and the housing GSEs. The cooperative structure of the System is essential to preserving the benefits that member institutions provide to communities and families and fund through advances. One of the many strengths of the System is the ability of each of the 12 Banks to develop and tailor products that meet the changing and diverse needs of their own members.

The FHLBank System needs a strong, independent regulator that has the authority to supervise the individual Banks using the current statutory framework of powers. Any new regulator of the FHLBanks must have the authority to maintain the Banks' access to the capital markets and their current well-defined mission to support the mortgage finance, affordable housing, and community development activities of member banks.

The independence of the regulator is another important element. The regulator must be able to operate outside of the appropriations process and be funded in a manner that allocates the system's assessments predominantly to the regulation and supervision of the system. The ability to fund operations without having to resort to the annual Congressional appropriations process will insulate the regulator from concerns about unintended political influence, and ensure autonomy. In addition, the assessments that the regulator makes on the FHLBanks must be used to examine and supervise the FHLBanks.

In 1989, two assessments were placed on the earnings of the System. The first, AHP, is funded out of contributions from the net income of each FHLBank. The total contribution from all FHLBanks is required to be a minimum of $100 million or 10 percent of earnings each year. This money is then allocated based on an application process developed by the FHFB. The projects that receive funding include many housing and community development projects. This program is a good example of how special affordable housing and community partnerships can be funded by an assessment on the System. We strongly support the very successful AHP as it is structured and would not recommend any changes. As noted previously, we suggest that this model be used as Congress contemplates a similar initiative as it relates to Fannie Mae and Freddie Mac. Involving the primary market lenders is an excellent way to promote development.

The second assessment on the System is the obligation toward repayment of the interest on the RefCorp obligations. Each bank must pay an amount equal to 20 percent of net earnings to repay the obligations incurred in the 1980's. These assessments are a legacy obligation of the

System and are part of obligations which Congress imposed on the System, along with other mission requirements. This costly obligation will not expire until 2030.

The FHLBanks' stock and debt instruments should be subject to transparent disclosures that are appropriate for this unique GSE. In June 2004, the FHFB issued a final rule requiring that each Federal Home Loan Bank register a class of securities with the SEC under the Securities Exchange Act of 1934. The disclosure scheme that has been established for public companies contains a number of requirements that make it difficult for a cooperative System to comply. We support the inclusion of certain specific securities law exemptions in any legislation. Such exemptions will make it easier for the FHLBanks to register and comply with the disclosure requirements, but will also make it easier for interested parties to understand the disclosures and the business of the FHLBanks. In particular, ACB supports a specific provision that would exempt the FHLBanks and the System from certain requirements of the SEC's Regulation FD.

The current corporate governance structure of the FHLBank System has been established by statute. Over the years certain governance functions have been devolved from the regulator to the FHLBanks themselves. The composition of the Boards of the each of the FHLBanks is a critical element in ensuring that the governance of the FHLBank is strong and balanced. As each of the FHLBanks has evolved into more sophisticated financial institutions, we believe that financial, business and operating expertise must be demonstrated by the Board of Directors of each FHLBank. Each FHLBank should have a Board that is composed of members with a stake in the System who understand the commitment and importance of serving on a FHLBank Board. As the financial structure of the Banks becomes increasingly complex, it is important to have strong financial qualifications for all directors so that they can effectively oversee the FHLBanks' operations.

Recently the FHFB passed a final interim rule to address the growing number of vacancies on the FHLBank boards in the Public Interest Director category. The rule called for the FHLBanks to provide the names of 2 candidates for each public interest director vacancy they have on their board. Although we commend the FHFB for seeking a solution to fill the boards, it is our preference that the boards be populated through an election, rather than appointment process. There is no regulator who knows the strengths and weaknesses of the boards better than the banks themselves. Even the current Chairman of the Federal Housing Finance Board agrees, and has state repeatedly that the regulator should not be in the position to appoint the regulated.

I wish to express my appreciation for this opportunity to testify on this important issue. The bright future of the FHLBanks and a strong well-regulated secondary market is a necessity to the day to day operations of many community banks, including South Shore and the communities we serve. I look forward to working with you and the members of the Subcommittee as the legislative process continues.

Testimony of

Mike Menzies
Vice Chairman, ICBA
President & CEO, Easton Bank and Trust Company

On behalf of the

Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Hearing on

"Legislative Proposals on GSE Reform"

March 12, 2007
Washington, D.C.

Chairman Kanjorski, Ranking Member Pryce and members of the committee, my name is Mike Menzies, I am President and CEO of Easton Bank and Trust Company in Easton, Maryland, and I am pleased to testify today in my capacity as Vice Chairman of the Independent Community Bankers of America (ICBA). ICBA appreciates this opportunity to testify on proposals to improve the regulation of the housing government sponsored enterprises, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

ICBA Supports Improved GSE Regulation

ICBA strongly supports efforts to improve the regulation of the housing GSEs. These institutions are vital to thousands of our nation's community banks. Like many community banks, Easton Bank has greatly benefited by a robust secondary market which enables us to sell mortgages and invest in mortgage-backed securities.

Though very different in key respects, all three of the GSEs provide community banks with irreplaceable access to the capital markets. This access allows our members to offer the same home mortgage products to our customers that the largest firms offer to theirs. In addition, the FHLBanks provide members advances for liquidity and asset/liability management. Thus, the GSEs need a strong, independent safety and soundness regulator to ensure they remain reliable sources of funding and liquidity for decades to come.

Chairman Frank, I would like to commend you for your leadership in the last Congress on this issue. ICBA was pleased to support the GSE reform legislation that cleared the House by a strong, bi-partisan vote. That bill contained many positive features including the creation of a world-class independent regulator, recognition of the unique structure and mission of the Federal Home Loan Bank System, and protection of the GSE status of the enterprises, which is so vital to ensuring the stability of the U.S. housing markets.

Because the GSEs are so important to community banks and their customers, ICBA urges Congress, in the strongest possible, terms to reject proposals that claim to improve GSE regulation but are actually designed to undermine their mission or pave the way for privatization. The mortgage marketplace already includes large private lenders that combine wholesale funding with aggressive national retail marketing. The housing GSEs make it possible to combine wholesale funding and community bank service at the local level. Rather than take any steps to undermine this unique mission, we recommend that Congress improve and enhance it by establishing a strong, independent regulator focused on safety and soundness.

There are a variety of ideas that could disrupt the functioning of the GSEs. One is to impose a cap on their growth or size. Another is to severely restrict the types of mortgage assets that could be included in their portfolios. ICBA strongly opposes the placement of arbitrary caps or limits without regard to the varying

needs of consumers over time. We believe that the GSEs should be able to operate within their mission without artificial limits. On the other hand, we understand that the regulator may need to impose growth limits for safety and soundness purposes. I will discuss this in more detail later in my testimony.

Structure of the Regulator

ICBA has long supported world-class, independent regulatory agencies, such as the Federal Deposit Insurance Corporation and the Federal Reserve, which are governed by boards independent of the Department of Treasury. These agencies have worked effectively. Following that same model, ICBA believes that the GSEs' safety and soundness regulator must be independent of political influence. The Treasury Department—whose primary responsibility is the fiscal policy of our country—should not direct the nation's housing policy, just as it should not direct its monetary policy, because doing so would create a conflict with Treasury's primary purpose.

While ICBA has had misgivings about including the FHLBanks within the new regulatory structure, we recognize that there is a consensus to do so. If Congress creates a new agency to oversee all three housing GSEs, that agency must be structured and directed to maintain the cooperative ownership structure, operations, and mission of the FHLBanks. Though they share some characteristics with Fannie Mae and Freddie Mac – primarily their substantial borrowings in the capital markets – the cooperatively owned FHLBanks are very different from the publicly traded housing GSEs, Fannie Mae and Freddie Mac. In addition, the FHLBanks' primary mission is to provide advances to their members for liquidity and asset/liability management. FHLBank advances enable them to make and hold mortgages and other types of loans in their own portfolios—loans that generally are not securitizable. Unlike Fannie Mae and Freddie Mac, the FHLBanks do not securitize mortgages and sell them to the public.

We note that last year's House bill (H.R. 1461) would have given the deputy for mission oversight responsibility for both the housing mission and goals for Fannie Mae and Freddie Mac, and the housing mission for the FHLBanks. ICBA believes that these responsibilities should remain separate, recognizing the unique nature of the FHLBanks.

Powers of the Regulator

Congress also should be cautious with respect to the powers that it confers on the new regulatory agency and its director. As a general rule, we believe that the powers of the new GSE regulator and its director should not surpass those at Federal banking agencies, particularly if the director will be operating independent of a board with executive authority. Given the enormous powers that have been discussed in the GSE debate, a director – unless fully

independent – could exercise significant political influence over the program and policy direction of the agency. The politically independent banking regulator model has worked well over the years, and Congress would be well served to follow it in this instance.

Secondary Versus Primary Market Activities

Congress should not attempt to draw a "bright line" between primary and secondary market activities of Fannie and Freddie. Frankly, the workings of the modern mortgage market are not as tidy as some have suggested. For example, automated underwriting systems (AUSs) devised by Fannie Mae and Freddie Mac have been criticized as straying too close to the line between primary and secondary market activities. However, primary lenders like community banks have found great value in the AUSs. They enable community banks to quickly and objectively qualify a borrower for a mortgage and determine if that loan is saleable.

Standardization is one of the major contributions that the GSEs have made to mortgage lending. It has leveled the playing field between the largest and smallest lenders, providing consumers more choice and better service. Without this standardization, a community bank would be forced to choose a single secondary market outlet for the loans its originates, rather than being able to seek the best pricing for its customers. Thus, the GSEs are expediting and reducing cost in the primary loan process. They are not interfering with or controlling the borrower.

Limits on Portfolio Growth and Composition

ICBA strongly opposes the placement of arbitrary, statutory caps on the size or composition of the housing GSEs portfolios. The GSEs must have the flexibility to expand and contract to meet the needs of the mortgage industry and ultimately consumers. Should statutory limits be placed on the GSEs, they may not be able to provide liquidity to lenders to meet heavy consumer demands for mortgages to buy new homes or refinance existing mortgages. Artificial limits on portfolio composition could have a similar effect.

We are also concerned that should statutory limits be placed on growth, Fannie and Freddie would be compelled by business reasons to give preference to their large volume customers. Under that scenario, community banks with relatively low origination volumes -- some as low as one or two mortgage loans a month -- would be shut out and not have a secondary market outlet. Under current rules, Fannie and Freddie can buy these loans for their own portfolios. Capping the GSEs' portfolios would seriously hamper the ability of our members to serve the mortgage needs of their customers.

I think it is also important to note that, from a macro perspective, placing limits on portfolio growth could make it difficult to raise the roughly $1 trillion in mortgage funding needed each year to assure stability in the housing markets. To help raise these funds, the market needs to attract investors from all over the world. Given the current concerns about subprime and "Alt A" lending, the ability of Fannie Mae and Freddie Mac to increase the size of their portfolios is becoming more and more important. This flexibility will ensure that credit will continue flowing to credit worthy borrowers with less than perfect credit or to those who need a mortgage with certain nontraditional features.

We recognize that there are options being considered that would grant the new regulator certain powers to restrain portfolio growth or limit their composition. We strongly caution against granting the new regulator overly broad authorities to limit portfolio growth or composition except when it is needed to ensure the safety and soundness of the enterprise. The GSE regulator should have supervisory and examination tools, comparable to bank regulators, to control portfolios for safety and soundness reasons. These limits should not be used as tools to implement political ends. We are concerned that overly broad authority to limit growth or the composition of portfolios may become politicized, and subject to undue political interference. Therefore, any authority should be carefully crafted. As a general rule, we believe the new GSE regulator should have the same powers as bank regulators, not more.

Capital

The new GSE regulator also will be able to regulate growth for safety and soundness reasons through adjustments to risk-based capital. A strong, independent regulator should have the authority, consistent with the current authority of banking regulators, to establish, and modify as necessary, risk-based capital the GSEs must hold to ensure their safety and soundness.

However, the regulator should not be permitted to use capital levels to change the nation's housing policy. Congress should maintain control over the statutory or minimum capital standards for Fannie Mae and Freddie Mac, as currently is the case. Otherwise, a new regulator could be subject to political pressure to adjust program levels by raising minimum capital, reducing the amount of resources available for housing. This would give the regulator a degree of authority over housing levels in the United States that we feel is inappropriate.

In establishing the housing GSEs, Congress made the determination that housing is of sufficient importance in the economy and society that it should receive this special support. We have been concerned that support of housing could be significantly altered as the regulator changes with the administration. We do not see it in the best interest of our country's well being to expose housing to this potential volatility.

Improvements to FHLBanks' Community Financial Institutions Program

ICBA believes that Congress should set the specific missions for GSEs, including the FHLBanks, Fannie Mae, Freddie Mac and the Farm Credit System, and that the regulator should ensure that they are meeting their mission. The current statute refers to the fact that the FHLBanks have a "housing finance mission." This should remain. But in the Gramm-Leach-Bliley Act of 1999, Congress allowed FHLBank members that qualify as Community Financial Institutions to use long term advances for small businesses, small farms and small agri-businesses (and pledge loans to small business and agriculture as collateral), thereby expanding the mission of the FHLBanks beyond housing.

While some FHLBanks moved forward rapidly to help their members serve small businesses and agriculture, others have not. We do not think Congress envisioned these new authorities would be implemented in only certain FHLBank districts. The vast majority of Community Financial Institutions cannot pick and choose which FHLBank to take their business to, unlike the largest banking companies that have charters in more than one FHLBank district.

Therefore, ICBA urges Congress to clarify that, in addition to housing finance, the mission of the Federal Home Loan Banks includes providing liquidity and economic development funds to community financial institutions to serve their small farm, small agri-business and small business customers. Language providing this was included in the Senate Banking Committee version of GSE reform legislation in the last Congress. We hope you will include it in your legislation.

In addition, ICBA continues to strongly support a provision in the bill the House passed in the 109th Congress to increase the size of institutions eligible for the CFI program to $1 billion in assets (with annual adjustments). Taken together, these provisions would enhance the program that Congress authorized in 1999.

FHLB Multidistrict Membership

ICBA opposes permitting financial institutions to belong to more than one FHLBank using a single charter (multi-district membership). The current structure of the FHLBank system has worked well and there is no compelling reason to make changes in membership rules. The issues surrounding multi-district membership through a single charter are complex and many affect the FHLBanks' safety and soundness. Such membership could also undermine the existing regional structure.

Consolidation

ICBA strongly supports the regional structure of the FHLBs. Consolidation of FHLBs should be driven by members, not the FHLB regulator, unless necessary for safety and soundness needs. We recognize that consolidation in the banking

industry has significantly affected the FHLBanks. Some FHLBanks have grown, while others have shrunk. This trend may well continue. As a representative of nearly 5,000 community financial institutions, nearly all members of FHLBanks, I'm here to tell you bigger is not necessarily better. Community banks put a high value on the regional structure of the FHLBanks that exists today because it reflects their regional diversity. Consolidation should only be considered by the regulator in the event that a FHLBank faces financial difficulties of such a magnitude that it can no longer maintain independent financial viability. Any consolidation not due to financial difficulties must be member driven and member approved since the members are the owners and users of the FHLBanks.

Concentration in the FHLBank System

Concentration in borrowing through advances by the FHLBanks' largest members is of concern to ICBA. ICBA believes that this should be addressed by the system's regulator before a serious problem arises, such as default of a member that is a dominant advance borrower (and capital provider) or the loss of their business to another funding source. The regulator should establish concentration limits for advances for both individual FHLBanks and the FHLBank system to protect safety and soundness.

Affordable Housing Goals for the FHLBs

We have heard suggestions that perhaps the FHLBanks should be subject to goals for the purchase of mortgages from low-and moderate-income individuals and certain other targeted populations and areas as are Fannie Mae and Freddie Mac. We have also heard the suggestion that these goals should be applied to advances. ICBA is opposed to this for several reasons. First, the FHLBanks currently pay 10 percent of their earnings into their Affordable Housing Program that goes directly to providing affordable housing. It is easy to track how the AHP funds are used. Second, we have witnessed extensive debates between Fannie Mae and Freddie Mac and HUD, the agency that sets their goals, over how the goals are determined, performance is measured and whether they are meeting their goals despite extensive regulations. In our view, it is unnecessary to impose this burdensome, costly process on the FHLBanks when their AHP programs and contributions are already meeting these obligations.

We also strongly object to imposing housing goals on the use of advances. The vast majority of FHLBank members are subject to the Community Reinvestment Act and regulatory oversight to ensure they are promoting affordable housing and serving low- and moderate-income customers. Again, this would be a significant additional and redundant regulatory burden on the FHLBank members and their customers.

Needed Adjustments

While Congress need not, and should not, undertake fundamental changes to the structure and mission of the housing GSEs, several issues have arisen since Congress considered legislation in this area, particularly regarding the FHLBank System. We believe Congress can usefully address these concerns without getting bogged down in needless controversy.

FHLBank Mission is Expanded by G-L-B Act. As mentioned above, ICBA recommends that your bill include an amendment regarding mission that was included in last year's Senate Banking Committee bill. The amendment made clear that the mission of the FHLBanks includes providing support for small farms, small agribusiness, and small business financing, pursuant to the new Gramm-Leach-Bliley Act authorities.

FHLBank Public Directors. A number of changes have been made recently to the process of appointing public interest directors and electing member directors to the boards of the FHLBanks that warrant close monitoring in the coming election/appointment cycles.

The system of appointing public interest directors by the Finance Board (and the Finance Board's unwillingness to appoint them until recently) has been an area of concern. We support the Finance Board's recent decision to once again appoint public interest directors. Its recent interim final rule has made a substantial improvement over the previous system, within the constraints of the current statutory framework. ICBA believes that the rule fosters two key goals: reducing the role of politics in selecting public interest directors and enhancing the role of the individual FHLBanks in finding qualified directors with the expertise that the Bank needs.

While ICBA supports the rule, we believe that Congress could make additional beneficial changes. We support giving each FHLBank the authority to select a minority number of public interest directors, nominated by the board of directors and elected by members. In this manner, public interest directors can be selected to meet the particular needs of each FHLBank, and further reduce the role of politics. Selection of public interest directors by members rather than the regulator also enhances the independence of the regulator from the governance structure of an institution it regulates.

ICBA has urged the FHFB to closely monitor the implementation of recent regulatory changes to the process by which directors representing members are nominated and elected. It is imperative that FHLB boards--not FHLB staff or the FHFB or its staff--control communications to members in this process. Attached to this testimony is a comment letter that ICBA submitted to the Finance Board on this topic on February 23, 2007.

Compensation. In general, ICBA believes that it is proper for the boards of directors of the GSEs to set compensation policies. We also believe that Congress should consider removing limits on compensation for FHLBank directors. Their compensation was cut in 2000 and we think that Congress should reconsider levels so that FHLBanks are able to attract people of significant technical expertise to serve as directors. The regulator should promulgate regulations to guide boards in appropriately setting compensation policies. In setting compensation for the leaders of Fannie Mae, Freddie Mac and the FHLBanks, we recognize a balance must be maintained that reflects that these are GSEs conducting a public purpose, yet they are very complex financial institutions that need to attract highly skilled leaders.

Farm Credit System

Since Congress is now debating significant regulatory reforms to the regulatory oversight of Fannie Mae, Freddie Mac and the FHLBanks, it is a good time to look at the oversight of another GSE, the Farm Credit System. Unlike the other GSEs under discussion, the Farm Credit System engages in direct retail banking activities, competing directly with community banks. We have seen the Farm Credit System engage in significant mission creep and it clearly needs a stronger regulator to ensure that it is adhering to its Congressionally mandated mission. The regulator of the Farm Credit System must be made more independent and transparent, with enhanced risk assessment capabilities. The Farm Credit System is engaged in many of the complex financial transactions that the other GSEs engage in and the regulator must have the ability to ensure they are conducted in a safe and sound manner. The FHLBanks, Fannie Mae and Freddie Mac now must register stock with the SEC, so too should the GSE Farm Credit System. ICBA has communicated these views to the House and Senate Agriculture Committees and strongly urged them to address these issues.

This issue is especially important in a year such as this when Congress is considering renewal of the farm bill. We expect the Farm Credit System to attempt to expand into non-farm lending through this legislation. ICBA commends the leadership of this committee for your letter to the leadership of the Agriculture Committee highlighting this potential expansion into lending under the Financial Services Committee's jurisdiction. We will continue to work with you on this issue.

Conclusion

ICBA strongly supports efforts to improve the regulation of Fannie Mae, Freddie Mac and the FHLBs to ensure their long-term health and stability. Access to these GSEs is vital to the ability of community banks to provide financing options for housing, small businesses and agriculture. Many community banks rely on FHLBank advances for liquidity and asset/liability management. In this regard,

ICBA strongly opposes changing the GSE status of the enterprises that ensures capital market access.

As a general principle, the GSE regulator should have the powers held by banking regulators to supervise and examine insured depository institutions to ensure safe and sound institutions. The regulator must be independent of political influence. Its role should be to ensure the safety and soundness of the GSEs and to ensure they achieve their missions, but not to set policy for national homeownership levels.

Thank you for this opportunity to share with you the views of our nation's community bankers. I would be happy to answer any questions you or other committee members may have.

INDEPENDENT COMMUNITY BANKERS of AMERICA

TERRY J. JORDE
Chairman
JAMES P. GHIGLIERI, JR.
Chairman-Elect
CYNTHIA BLANKENSHIP
Vice Chairman
KEN PARSONS, SR.
Treasurer
ROBERT C. FRICKE
Secretary
DAVID E. HAYES
Immediate Past Chairman

CAMDEN R. FINE
President and CEO

Federal Housing Finance Board
Attention: Public Comments
1625 Eye Street NW
Washington, DC 20006

RE: Interim Final Rule, Federal Home Loan Bank Appointive Directors

To Whom It May Concern:

The Independent Community Bankers of America[1] welcomes the opportunity to comment on the Federal Housing Finance Board's Interim Final Rule that establishes procedures for the selection of Federal Home Loan Bank appointive directors. Section 7(a) of the Federal Home Loan Bank Act authorizes the FHFB to appoint directors to the board of each FHLB, but existing rules do not provide procedures for doing so. Members also elect directors to FHLB boards to represent their interests. The FHFB believes that by adopting procedures for the selection of appointive directors, it will enhance its ability to identify and appoint well-qualified individuals to serve as FHLB directors.

Proposed Procedures

On or before October 1st of each year, the board of each FHLB shall submit to the FHFB a list of eligible nominees who are well-qualified to fill the appointive directorships that will expire on December 31 of that year, along with a FHFB prescribed application form executed by each person on the list. If an appointive directorship becomes vacant prior to the expiration of its term, the board of directors of the FHLB shall submit a list of names in a like manner. The names of nominees on the list provided to the FHFB shall be 2 times the number of appointive directorships to be filled. The FHFB shall select from among the nominees on the list in appointing directors. If the FHFB does not fill all appointive directorships from the list initially submitted by the

[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

INDEPENDENT COMMUNITY BANKERS of AMERICA *The Nation's Voice for Community Banks*™
One Thomas Circle, NW Suite 400 Washington, DC 20005 • (800)422-8439 • FAX: (202)659-1413 • Email:info@icba.org • Web site:www.icba.org

FHLB, it may require the FHLB to submit a supplemental list of nominees for its consideration.

Anyone who seeks to be appointed to the board of a FHLB may submit to it an executed appointive director application form that demonstrates that the individual both is eligible and has business, financial, housing, community and economic development, and/or leadership experience. Any other interested party may recommend to the FHLB that it consider a particular individual as a nominee for an appointive directorship, but the FHLB may not do so until the individual has provided the FHLB with an executed appointive director application form. The board of directors of the FHLB may consider any individual for inclusion on the list it submits to the FHFB provided it has determined that the individual is eligible and well-qualified for the appointive directorship.

ICBA Comments

ICBA supports the procedures contained in the interim final rule (including the application form) and believes that they will make the selection process more transparent, enhance the quality of FHLB appointive directors and provide an opportunity for the selection of appointive directors that more closely match the needs of individual FHLBs.

ICBA also has several suggestions for the rule. First, we ask the FHFB to require the FHLBs to formally notify their members when they are seeking appointive director candidates. Some FHLBs are already doing this. FHLB members know and work closely with many individuals in their communities that would be highly qualified candidates. Members should be made aware of the selection process and how to submit candidate names.

Second, we ask that the FHFB clarify that if it does not fill all of the appointive directorships from the list initially submitted by a FHLB it **shall** rather than **may** require the FHLB to submit a supplemental list of nominees for its consideration. We believe that was the intent of the rule and the language change would clarify the process.

Third, we ask that the FHFB encourage the FHLBs to offer nominees who represent geographic diversity within the district. Nominees must be a bona fide resident of a state within the geographic area that the FHLB serves, but they could potentially come from a concentrated geographic area. Each FHLB serves members in a variety of states and in urban, suburban and rural areas. Elected directors represent geographic diversity and, to the extent possible, so should appointive directors.

We appreciate the opportunity to comment. If you would like to discuss our views further, please call me at (202) 659-8111 or email me at ann.grochala@icba.org.

Sincerely,

Ann M. Grochala
Director, Lending and Accounting Policy

INDEPENDENT COMMUNITY BANKERS of AMERICA The Nation's Voice for Community Banks™
One Thomas Circle, NW Suite 400 Washington, DC 20005 • (800)422-8439 • FAX: (202)659-1413 • Email:info@icba.org • Web site:www.icba.org

Testimony

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Before the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

March 12, 2007

It is an honor today to appear before this distinguished Subcommittee to discuss the urgent need to improve the regulatory framework of the housing government-sponsored enterprises (GSEs). I am Karen Shaw Petrou, managing partner of Federal Financial Analytics. I last testified before this panel on GSE reform in June of 2003, when I suggested that the problems then evident at Freddie Mac were also a serious concern at Fannie Mae. I argued then for significant enhancements to the Office of Federal Housing Enterprise Oversight (OFHEO). Since then, of course, Fannie Mae and Freddie Mac have both demonstrated severe internal-control failings that leaves them ill-prepared to meet their mission. At the same time, several of the Federal Home Loan Banks have shown similar problems. There is, thus, no longer debate over the need for a world-class GSE regulator with powers akin to those long granted the federal banking agencies.

Now, the debate turns on just what constitutes "bank-like" regulation and just how this should be adapted because of the unique nature of the GSEs. Here, the details can be critically important, as Congress learned at considerable cost when the failings at the S&L and banking agencies were revealed in the late 1980s and 1990s. Reflecting this lesson, the House in the last Congress passed H.R. 1461, a bill that is a substantial improvement over current law. Chairman Frank then worked closely with Treasury Secretary Paulson to enhance that bill, building a strong platform from which I hope the 110th Congress will move quickly to final passage of this long-overdue legislation.

Today, I would like to walk through key provisions in last year's legislation to highlight how they promote the bank-like regulator we all agree must soon be put in place for all of the housing GSEs. I will address the more controversial safety-and-soundness provisions: capital, new-product review, and the portfolio. However, I would also like to remind the Subcommittee of critical sections in the legislation – new prudential powers for the regulator, for example – that may not get as much attention as they deserve. Sometimes, long-accepted provisions in a bill surprisingly end up on the cutting-room floor in the middle of the night. Too much hard work and too disturbing a history at the GSEs have occurred to allow this to happen now.

Major points in this testimony include:

- The reform bill should, as provided in the pending compromise, give the new regulator discretion over the amount and components of GSE minimum and risk-based capital. To make the measure more "bank-like," the bill could also dictate standards for well-capitalized GSEs, not stipulate only that they be "adequately" capitalized as is now the case. Some have suggested the new regulator be allowed only to raise capital under defined, limited conditions, but this would be a sharp departure from banking-agency practice and prove particularly risky for the GSEs.

- The proposed compromise rightly provides for appropriate advance regulatory and public scrutiny of new GSE ventures. When Congress last reviewed this issue for banks (in Gramm-Leach-Bliley), it required such a process. This is why Congress learned in advance of the proposal to expand real-estate agency powers. Early warning of controversial GSE ventures is at least as vital. Unlike banks, GSEs are not subject to competition or market discipline that would otherwise provide early warning of new products and ensure appropriate risk mitigation.

- Different proposals are under consideration regarding GSE portfolios. It should be noted that banks are in fact subject to express portfolio limits. For example, these bar commercial investments.

- H.R. 1461 as passed included specific direction to the new regulator to issue rules or guidance on topics such as asset quality, credit and counterparty risk, operational risk and liquidity. These are now major gaps in the GSE rulebook and this language should be maintained to ensure a specific mandate for the standards on a short turn-around.

- H.R. 1461 as passed also included important corporate-governance standards not in last year's Senate bill. These would strengthen the new regulator's hand in an area in which the GSEs have shown significant problems.

Capital Requirements

It is my understanding that the proposed legislation would eliminate the restrictions in current law that block the GSE regulators – both OFHEO and the Federal Housing Finance Board (FHFB) – from setting minimum and risk-based capital without the minimums and other restrictions set in law for Fannie and Freddie in 1992 and the FHLBanks in 1999. The bill would also expressly authorize the new regulator to set capital and – importantly – reserves not only for each GSE, but also on a product-by-product basis. Some have argued against this, based on the view that the unique nature of the GSEs argues for significant constraints on their regulator, but I believe Congress should enact legislation along the lines included in the pending compromise proposal.

If I may, I would like quickly to outline what bank regulators do on regulatory capital and how this applies to the housing GSEs:

- First, Congress has given the regulators full authority to set minimum and risk-based capital. It has, however, also specified the level at which a bank is deemed "well capitalized," as well as sanctions that must apply as capital falls. The pending legislation requires only that GSEs be "adequately" capitalized, but flexibility should be provided to ensure that GSEs meet or

exceed this minimum capital level. The bill also enhances the sanctions that must be applied under "prompt corrective action" provisions, a critical (if often overlooked) proposal that should be included in final legislation.

- Bank regulators have flexibility over what constitutes capital because of significant market changes that often warrant regulatory rewrites. For example, derivatives were not envisioned in 1988 when the current capital rules were crafted, leading the banking agencies to a series of significant revisions and the pending overhaul in the Basel II rules. The anachronistic and specific nature of the current GSE capital standards makes it very difficult for the regulator not only to react to change, but – more importantly – to anticipate it.

- Bank regulators can and often do require one bank to hold more capital than another based on a risk profile. Specific statutory minimums assume all GSEs are alike, which history has proven they are not.

- Bank regulatory capital standards are supplemented by additional charges for concentration risk – that is, big bets on one thing. The new GSE regulator must have authority to compensate for the fact that GSEs are exposed principally to only one risk – that related to residential mortgages. This is the classic "all the eggs in one basket" problem and the new regulator should be equipped in advance to compensate for it with appropriate capital. The regulator should also have full authority to stress test minimum capital requirements, again paralleling what the banking agencies do.

New-Product Powers

It is my understanding that the compromise legislation includes new-product authority for the GSE regulator similar to that in last year's Senate legislation. This is, I believe, a considerable improvement over the new-product language in H.R. 1461 and should be included in the final legislation.

There are, to be sure, differences in the way each of the banking agencies looks at new ventures, complicating a precise "bank-like" comparison. However, there's one clear parallel: the last time Congress looked at this issue, it opted for advance public notice and comment before regulators authorized new ventures. This was the model included in the Gramm-Leach-Bliley Act in 1999. As you know, it was precisely this provision which alerted Congress to proposed new real-estate agency and brokerage powers for financial holding companies. Congress, like all other interested parties, should get advance warning of any new ventures contemplated by the GSEs to be sure they are prudent, consistent with the GSEs' mission and, if approved, that appropriate safeguards are in place in advance.

Transparency is always beneficial, but it's particularly important when market discipline doesn't apply, which is the case for the GSEs. Banks have many competitors in and out of the business, which means push-back if a regulator goes too far and allows inappropriate ventures without public scrutiny. GSEs, however, only compete with each other. This means that high-risk, non-mission ventures would start without the needed early warning that would protect market efficiency, vulnerable borrowers and the financial system more generally.

Because of their implicit guarantee, GSEs fund themselves at far lower cost than other market participants, including large banks. As has been proven in the last few years, GSE risk premiums – that is, the difference between their borrowing cost and that of the Treasury – did not rise even as Fannie Mae and Freddie Mac ceased to file current financials. This means that, if a GSE launches a new venture, it has formidable power with which quickly to control a market. Even seemingly minor ventures can be important sources of profit or customer service to other institutions, including community banks. Thus, early warning of all new ventures must be insured in the reform legislation.

Would the GSEs get into high-risk, non-mission ventures? They have tried in the past and doubtless will again, especially if portfolio restraints pressure shareholder returns. Fannie Mae has, for example, received a patent that ostensibly protects its right to engage in a wider range of mortgage ventures and, going farther, consumer finance. Fannie Mae and Freddie Mac are also considering new ventures in the credit-derivatives arena. Credit derivatives are over-the-counter traded complex financial instruments that transfer credit risk between buyers and sellers. Initially developed for corporate credit, credit derivatives are now beginning to be used in residential mortgages. They are, though, a very new product that has yet to be tested under the stress now evident in the mortgage sector. In areas where credit derivatives have been used for longer periods of time, the Federal Reserve and other bank regulators have significant concerns. Credit derivatives are increasingly used by hedge funds and other speculative investors not to transfer risk, but instead to take short-term bets. If Fannie Mae or Freddie Mac weighs into this market, they could do so with tremendous market clout because of their implicit guarantee, even as their bets are backed with far less capital than required of regulated market participants.

Some have suggested that a bank-like prior product review would be "cumbersome" and slow down needed innovation. To counter, I would first note that the FHFB has in the past issued proposals for public comment before authorizing new programs like the Mortgage Purchase Plan for the Home Loan Banks. This was wise, as the initial proposal lacked many of the safeguards that now insulate the Banks from some of the risks of these ventures. More importantly, though, one should look at the broader U.S. banking system. It's by far the most innovative in the world and this occurs despite the need for prior supervisory review.

GSE Portfolios

The degree to which the legislation should limit the portfolios held by Fannie Mae and Freddie Mac is, of course, a major bone of contention as the final legislation is crafted. There are numerous ways to set a portfolio limit to address systemic risk, perhaps taking Chairman Bernanke's suggestion last week to ensure an improved GSE focus on affordable housing.

Some have said that there are no comparable constraints on bank holdings, thus suggesting that a portfolio limit violates the "bank-like" regulatory context at which all say they aim. However, the law in fact is quite specific on what assets may and may not be held by a bank and any of its affiliates. The law stipulates, for example, that banks may not hold commercial assets. When these are held in financial holding-company merchant-banking subsidiaries, as authorized under Gramm-Leach-Bliley, the law contains numerous safeguards to protect against prudential risk and conflicts of interest. Numerous percentage limits – loan-to-one-borrower ones, for example – also both define bank portfolios and limit risk.

Other Facets of Bank-Like GSE Regulation

In addition to these high-profile issues, many provisions in H.R. 1461 and the pending compromise are critical to ensure the new GSE regulator is fully empowered. As Chairman Bernanke made clear in his speech on March 6, none of the housing GSEs is subject to market discipline. If there were any doubt on this point, the GSEs' ability to maintain their AAA ratings as they fall ever farther behind on financial statements should dispel them. Market discipline is one of the three "pillars" in the global bank-regulatory framework adopted by the Basel Committee. Without it, it is even more essential that GSE capital and prudential standards be at least as robust as those applied to banks

With this in mind, the following provisions in H.R. 1461 and/or the pending compromise are essential components of effective GSE regulation:

- Meaningful, Mandatory Prudential Standards: H.R. 1461 (Section 102) requires the new regulator to issue rules, orders or guidance on an array of critical prudential issues. The list in the House bill is more complete than that in S. 190 and the requirement is mandatory, not optional. The House language is thus preferable to ensure that the new regulator moves quickly to issue standards comparable to those long in place for insured depositories and their holding companies.

- Corporate Governance: H.R. 1461 (Section 114) includes specific corporate-governance standards for Fannie Mae and Freddie Mac not included in the Senate legislation. This language clarifies OFHEO's authority to impose

appropriate corporate-governance standards, ensuring attention and improvement in this critical area.

- Receivership: Both the House and Senate bills rightly give the new GSE regulator authority to put a GSE into receivership if critical capital thresholds are crossed or other threats to solvency occur. In the conservatorship now permitted, the government would step in and act as the GSE, protecting investors from loss and reinforcing the view that the GSEs are guaranteed by the Treasury. Under a receivership, in contrast, a bankruptcy-like process would be put in place to provide for greater market discipline. This is how large banks are handled, even in the event of systemic-risk situations and it should be the model for the GSEs going forward.

- M&A Review: Both the House and Senate bills expressly provide that the regulator may review acquisitions or transfers in a GSE's controlling interest in advance. This is comparable to the power the banking agencies have over acquisitions and changes in control. Absent this authority, a GSE could effectively transfer its government status to a large private person without any advance warning to its regulator or any chance for the regulator or Congress to intervene.

- Regulatory Independence: All of the pending bills rightly structure a new regulator freed from the appropriations process and insulated from undue political influence. H.R. 1461 does include a board that reviews the GSE regulator. If this provision is retained, it should be kept as is to avoid undue influence or inappropriate delay in regulatory actions. In the past, all of the housing GSEs have had success capturing their regulators and preventing them from needed prudential action in critical areas like capital controls. This must not happen again.

- Enforcement: With some differences in detail, all of the bills would significantly enhance the ability of the new GSE regulator in contrast to the powers now provided to OFHEO and the FHFB with regard to such critical issues as institution-affiliated parties, the timing of enforcement actions, the penalties that can be imposed and the ability of the regulator to act without the consent of a regulated entity. It should be noted that this new enforcement framework is comparable to that of the bank regulators, not that of the SEC or FTC, which rely on post-hoc punitive measures frequently cited as potential constraints on corporate innovation and competitiveness.

Statement of

John R. Price
President and CEO
Federal Home Loan Bank of Pittsburgh
On behalf of the Council of Federal Home Loan Banks

Before the

House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

March 12, 2007

Chairman Kanjorski, Ranking Member Pryce, and Members of the Subcommittee, I appreciate the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks (Council) about the Federal Home Loan Banks (FHLBanks) and legislative proposals to reform regulation of the housing government-sponsored enterprises (GSEs). My name is John Price, and I am President and CEO of the Federal Home Loan Bank of Pittsburgh (FHLBank Pittsburgh).

Before I address the issues presented by today's hearing, I would like to give a brief overview of FHLBank Pittsburgh. One of the twelve FHLBanks, FHLBank Pittsburgh helps our 334 member/owner financial institutions meet the housing and community development credit needs of communities throughout Pennsylvania, Delaware and West Virginia, just as the other eleven FHLBanks provide similar service to over 8100 financial institutions across the country. At year-end 2006, FHLBank Pittsburgh had assets of $77 billion.

As a cooperative, FHLBank Pittsburgh is an active partner with our members as they serve individual consumers, affordable housing providers, homebuilders, small businesses, and local governments across their markets. Helping a first-time low income homebuyer experience the American Dream of homeownership through our First Front Door program, assisting thousands of families to secure decent and affordable housing through the Affordable Housing Program (AHP), providing thousands of employees at hundreds of small businesses an important boost through our Banking on Business program, and helping communities meet such pressing needs as water treatment repairs through our Community Lending Program or letters of credit are some of the results of this partnership.

At the outset I would like to commend you, Chairman Kanjorski, for your continued interest and strong support of the FHLBank System (System) , and your commitment to ensuring that the System operates in a safe and sound manner with the best corporate governance practices. Likewise, Ranking Member Pryce, I commend you

for your commitment and hard work to ensure that all the GSEs have a truly world class regulator with the necessary powers to ensure that the GSEs fulfill their missions in a safe and sound fashion.

The Council, which represents all twelve FHLBanks, believes it is important to resolve the legislative uncertainty and is supportive of your efforts toward the creation of a strong independent regulator for the housing GSEs.

FHLBank Overview

The FHLBanks and their members are the largest source of residential mortgage and community development credit in the United States. The FHLBank System is comprised of twelve independently owned and operated regional FHLBanks, their 8,100 member financial institutions (federally insured savings associations, savings banks, commercial banks, credit unions, and insurance companies). The Office of Finance serves the FHLBanks by issuing debt on behalf of the twelve regional FHLBanks for which the FHLBanks share joint and several liability. The twelve FHLBanks use that debt to provide, as of the end of 2006, over $641 billion of outstanding loans, known as advances, to member institutions, serving virtually every community in America. The FHLBanks are overseen by an independent regulator, the Federal Housing Finance Board (Finance Board).

While the System operates under a congressional charter with a housing mission similar to Fannie Mae and Freddie Mac, the FHLBanks are fundamentally different in structure, business model and perspective from these institutions. No other housing GSE operates under the same decentralized, regional structure as the FHLBanks, or is structured as a cooperative, owned and controlled by its members. The System's member/owners are also its customers. As cooperatives:

- FHLBanks issue no publicly traded equity stock.

- FHLBanks' member-contributed capital, which capitalizes the Bank System, does not trade on any market and does not fluctuate in value.
- No FHLBank officer or director receives any stock options or any stock related compensation; thus there is no incentive to manage or manipulate earnings in order to reap the benefit of options.

As a result of the cooperative structure, the return on equity profile of the FHLBank System is far different from that of Fannie and Freddie, which, as publicly traded companies, face public stock holder demands for return on equity. Rates of return on FHLBank stock have approximated the fed funds rate, in the neighborhood of three to five percent in recent years, far below the return expected from publicly traded corporations. For many of the System's members, their largest single asset on their balance sheet is their FHLBank stock – making the FHLBank's safety and soundness and their continued access to their FHLBank of paramount importance.

Member institutions use the FHLBanks' advance programs to meet the housing, community and economic development lending needs of their local markets. The vast majority of our members are not large enough to access the broadest range of capital market options on their own. FHLBank advances are the only capital market access for many FHLBank members and serve as an important resource to deal with any possible future credit crunches. Advances are a reliable, accessible funding source available during all phases of the business cycle. This means that community credit needs can be met in any number of economic scenarios. It also means that FHLBank members are safer, from a regulatory perspective, than financial institutions would be without access to FHLBank funding programs.

The fact that FHLBank members can borrow at any time from their FHLBank allows them to be more active lenders in their communities. FHLBank members can also structure FHLBank funding in terms of maturity and conditions to meet strategic asset-liability management goals or to fund specific lending products.

In addition, the FHLBanks' mortgage purchase programs provide members, particularly smaller-sized institutions, a desirable secondary market alternative. The ability of FHLBanks to purchase mortgages is a very important aspect of the mission to provide liquidity to our member institutions and has allowed many of our smaller members to offer 30 year mortgage products for the first time. Each FHLBank is especially focused on the need to manage the risks associated with these programs in a sophisticated and safe fashion. While the FHLBanks may have differing views on how to best manage these mortgages, I believe most Banks recognize the need to develop, over time, appropriate risk transfer methods with respect to these programs.

FHLBanks represent the largest private sector source of grants supporting low income housing. FHLBank members also utilize the AHP to help thousands of low-income families obtain housing. FHLBank AHP contributions were approximately $295 million in 2006, up from $282 million in 2005, due to the increase in earnings for that year. As a direct result of this program the FHLBanks have awarded over $2.5 billion to create more than 520,000 affordable housing units since 1990. I will address this program in greater detail later in my statement.

Significant Past Legislation: The FHLBanks were created in 1932 to support America's housing finance system through thrift institutions and insurance companies. Over the System's seventy-five year history, the Congress has taken an active role in defining the mission and structure of the System. Two critical pieces of legislation shaped today's FHLBanks:

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)

- expanded membership to include commercial banks and credit unions with a demonstrated commitment to housing finance;
- created the System's Resolution Funding Corporation (REFCorp) assessment on FHLBank earnings;

- established the AHP through which each FHLBank sets aside 10 percent of net earnings annually for the support of affordable housing throughout the nation; and
- required FHLBanks to establish Community Investment Programs (CIP) for members to undertake community-oriented lending, including affordable housing.

Title VI of the Gramm-Leach-Bliley Act of 1999, sponsored by Chairman Kanjorski and Congressman Baker, established universal voluntary membership; provided for a permanent capital structure; expanded the types of collateral that community institutions can pledge to secure advances, and increased the independent corporate governance of each FHLBank.

These two pieces of legislation, combined with the performance of the FHLBanks in the marketplace and customer demand for FHLBank products, resulted in considerable growth over the last decade. As of December 31, 2006, the FHLBanks had combined total assets of $ 1 trillion compared to $241 billion a decade ago. This growth is a direct result of an increase of more than 2,800 members in the past 10 years to just over 8,100.

SEC Registration Status and Return to Scheduled Combined Financial Reporting: As of August 8, 2006, all twelve FHLBank SEC registrations were effective, and all have current financial reports on the SEC EDGAR database. On November 8, 2006, the 2005 Combined Financial Report for the Federal Home Loan Bank System was published, marking a major milestone in the System's return to scheduled combined financial reporting. It is expected that scheduled combined financial reporting will resume with the publication of the 2006 Combined Financial Report by March 31, 2007, and continue with subsequent quarterly reports for 2007.

FHLBank Affordable Housing Programs

I would like to go into greater detail about a central aspect of the FHLBanks' public mission, the AHP. Pursuant to FIRREA, each of the twelve FHLBanks is required by statute to contribute at least 10 percent of its previous year's net earnings to the AHP,

subject to a minimum annual combined contribution by the twelve banks of $100 million. The statute requires AHP subsidies to be used to finance homeownership by families with incomes at or below 80 percent of the median area income, or to finance the purchase, construction, or rehabilitation of rental housing in which at least 20 percent of the units will be occupied by and affordable for families with incomes at or below 50 percent of the area median income. These subsidies may be in the form of grants or below-cost interest rates on advances from the FHLBank to member lenders.

AHP funds are awarded through a competitive application program run by each of the FHLBanks as well as through a homeownership set-aside program established by the Finance Board. Since its beginning, the AHP has resulted in the FHLBanks having awarded approximately $2.5 billion in grants through their members, making it the largest private source of affordable housing support in the nation.

A key strength of this program is the flexibility it provides to FHLBanks to adapt to differing community needs across the country. AHP can be used to support a wide array of affordable housing projects – rental and owner-occupied as well as single-family and multi-family units. Unlike some other programs, AHP can be used for both housing rehabilitation and new construction, and can be used to augment other sources of funding by filling in gaps.

As do all the FHLBanks, FHLBank Pittsburgh relies on the expertise of its Affordable Housing Advisory Council, a blue-ribbon group of housing experts from West Virginia, Pennsylvania and Delaware that advises our Community Investment Department and our Board of Directors in operating the AHP. Because the System's structure allows each FHLBank to respond to different regional needs, a variety of approaches can be developed. An example is this year's FHLBank Pittsburgh pilot Housing Rehabilitation Program (HRP) that will provide housing repair and rehabilitation assistance to homeowners earning 80 percent or less of the median family income for their area. Eligible uses of HRP funds include rehabilitation assistance in connection with

the rehabilitation of an owner-occupied housing unit to be used as the household's primary residence.

Mr. Chairman, knowing of your particular interest in and leadership surrounding FHLBank efforts to support community development to complement our main mission of providing liquidity to members and supporting affordable housing, I wanted to take a brief moment to highlight what FHLBank Pittsburgh is doing in that regard. As an independently owned and operated cooperative, our approach may be somewhat different from other FHLBanks. One of the valuable aspects of the System's unique structure is that each FHLBank can develop programs that best meet its district's local and regional needs.

Banking on Business Program (BOB): The BOB program helps eligible small businesses with start-up and expansion costs. Each BOB dollar the FHLBank contributes typically leverages an additional $6 in financial resources to small businesses in the region, thereby creating or retaining jobs and improving local communities. BOB offers recoverable assistance to be leveraged with member financing to help small businesses that need it most.

Since 2000, FHLBank Pittsburgh has funded more than $27.5 million in BOB funding to assist small businesses in our district, creating or retaining more than 3,821 jobs. Examples of these businesses include: Analytical Biological Services of Wilmington, Delaware, a testing lab that produces tissue membrane preparations for pharmaceutical companies in the drug discovery process; the Grace Dental Practice in Cabin Creek, WV; Expansion of Custom Processing Services, Inc., an air milling and particle size reduction company headquartered in Reading, PA, and Nazar Diesel of Jessup, PA, a diesel engine repair business. This year, we will be committing $7 million in new funds.

Community Lending Program (CLP): Referred to as the Community Investment Program (CIP) by other FHLBanks, is an $825 million noncompetitive revolving loan

pool that offers loans to member financial institutions for community and economic development projects that create housing, improve business districts and strengthen neighborhoods. For example, CLP recently helped three northeastern Pennsylvania municipalities upgrade their public water and sewer systems with $8 million in flexible, low interest financing ensuring timely completion of the work at a reduced cost to taxpayers. System-wide, CIP lending since program inception totals over $44 billion, financing over 600,000 housing units and thousands of economic development projects

Blueprint Communities: FHLBank Pittsburgh, in cooperation with multiple partners, has developed *Blueprint Communities*, a neighborhood revitalization initiative that will serve as a catalyst for creating sustainable neighborhoods in Delaware, Pennsylvania and West Virginia. This community revitalization training emphasizes a team approach and will provide the educational component necessary for communities to begin developing long-term, comprehensive community plans. Launched in 2005, this program involved 22 urban and rural communities across Pennsylvania and is expanding to West Virginia this year and Delaware in 2008. In fact, the announcement of West Virginia's 10 participating communities took place earlier this morning.

Investments: FHLBanks regularly invest in housing agency bonds and other public finance investments. FHLBank Pittsburgh has invested in specialty community development and municipal financings. As with housing authority bonds, all of our investments are taxable rather than tax-exempt. Working either directly with the municipal authority or through securities dealers, FHLBank offers flexibility of terms not normally encountered in traditional underwritings.

Letters of Credit (LOC): FHLBank Pittsburgh's LOC product can be used to help members to improve the credit rating for tax-exempt housing bonds, taxable community lending and public finance transactions, including bond issues. Additionally, LOCs can be used by FHLBank members to secure municipal deposits.

LOCs have been used to help finance water filtration plants; assisted living, senior care and nursing home facilities; community centers; and health care facilities. Additional uses have been for economic development, downtown re-development, low to moderate income housing developments, and general housing needs.

With respect to FHLBank LOC's, I would like to briefly mention important tax legislation that will help local communities raise tax-exempt funds for infrastructure improvements, industrial development, public healthcare facilities, fire stations, water treatment facilities, long-term care for the elderly, schools and other important activities.

Introduced in the 109th Congress as HR. 5177 by Ways and Means Committee members Phil English and Sander Levin, the legislation which has not yet been introduced in the 110th Congress, amends Section 149 of the Internal Revenue Code (IRC) to add FHLBanks to the list of GSEs that can credit enhance tax-exempt municipal bonds. Fannie Mae, Freddie Mac, FHA, and VA have been permitted since 1984 under the IRC to issue these LOCs. At that time, the FHLBanks' mission did not include community and economic development (it was added by FIRREA in 1989), now it does.

This legislation would allow FHLBank member banks to assist municipalities, certain health care facilities, and institutions of higher learning in lowering their funding costs when issuing tax-exempt bonds. The bill would allow FHLBank LOCs to support these bonds without triggering the loss of the bonds' tax-exempt status.

In addition to the Council, the legislation is supported by the American Bankers Association, America's Community Bankers, the Independent Community Bankers of America, the Mortgage Bankers Association, the National Association of Homebuilders, National Association of Higher Educational Facilities Authorities, the National Council of Health Facilities Finance Authorities, the National League of Cities and the US Conference of Mayors.

I would also like to thank you, Mr. Chairman, Full Committee Ranking Member Bachus and Committee Members Baker, Gerlach, Gillmor, Jones, Pryce, and Scott for your strong support of this legislation. We look forward to working with you on this legislation in this Congress.

Key Elements for a Positive Future

The FHLBanks can best support and build upon our successful record with a strong, independent regulator, engaged corporate governance, and effective risk management.

Independent Regulator: Under our current regulatory regime, the Finance Board's primary duty is "to ensure that the FHLBanks operate in a financially safe and sound manner." Our current regulator already has the powers accorded to traditional federal banking regulators.

- The Finance Board is not limited by funding constraints or congressional appropriations processes in carrying out its responsibilities. Its funding is provided by assessments on the FHLBanks that are not subject to review or challenge by the FHLBanks.
- Finance Board regulations govern a broad range of FHLBanks' operations including advances pricing, risk management, capital plan approval, directors' responsibilities and new business activities.
- The Finance Board also collects and monitors financial and risk management data from the FHLBanks each month, performs ongoing reviews of all aspects of the FHLBanks' operations and conducts annual on-site examinations of all twelve FHLBanks.

The FHLBanks all believe that it is essential to maintain a strong, independent regulator with the resources and authority to ensure the FHLBanks' continued safety and

soundness and mission achievement. This independence has been a key element in the long-term safe and sound track record of the FHLBanks.

Sound Corporate Governance: Finance Board regulations require the FHLBanks' boards of directors to fulfill today's corporate director duties. These include the responsibility to select and oversee management, ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, a member products policy that details the FHLBank's credit and pricing policies, and the responsibility to approve the FHLBanks' annual operating and capital budgets and quarterly dividends.

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

On the issue of appointive directors for the FHLBanks, I would like to note that the Council has been very concerned about the lack of appointments. In fact, on October 2, 2006 the Chairs and Vice-Chairs of all twelve FHLBanks wrote the Finance Board urging that appointments be made. The Finance Board recently issued an interim final rule that institutes a formalized process for selecting and appointing directors to the FHLBanks that provides a significant role for each of the FHLBanks in the appointment process. The Council supports this rule and believes that it will improve the process for selecting appointed members for the boards of directors of the FHLBanks.

In order to deal with the current vacancies, the Finance Board's rule requires the boards of directors of the Banks to submit a list of eligible and qualified individuals to the Finance Board on or before March 31, 2007. At this time, the Boards of each of the twelve FHLBanks are actively engaged in the process of nominating candidates for these appointive directorships.

Risk Management: As one of twelve independent institutions, the FHLBank Pittsburgh is responsible for its own risk management activities. Our risk profile is guided by a number of regulatory factors common across the System. FHLBanks are subject to a minimum 4.0 capital-to-asset ratio as well as a risk-based capital requirement. The FHLBank minimizes credit risk by over-collateralizing advances, limiting investments to highly rated securities, and establishing appropriate risk sharing features for mortgage purchase programs. No FHLBank has ever suffered a credit loss on an advance to its members in its 75-year history.

One source of risk to the FHLBanks is interest rate risk. Each FHLBank uses sophisticated, high quality financial models to continually assess the magnitude of the risk to earnings and the estimated market value of equity and earnings from changes in interest rates, mortgage prepayment speeds, and other market variables. A part of this process does involve the use of various derivatives such as interest rate swaps. Derivative positions are marked to market on a regular basis and appropriate collateral is in place at all times. Financial management policies limit the use of derivatives to hedging only. Like all users of derivatives, the FHLBanks are governed by complex accounting rules required for these transactions.

Beyond the board-established policies which conservatively limit a FHLBank's risk profile, the cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk exposure in search of higher returns. The primary mission of the cooperative is to provide member institutions the funding and financial services they need to meet the credit needs of their communities.

At the same time, the FHLBank must generate an adequate dividend return to member shareholders that meets their opportunity cost of investing capital in a low risk enterprise.

Guiding Principles for Legislative Reform

The combination of active legislative oversight, an independent regulator, engaged boards of directors and extensive risk management tools has proven to be effective for the FHLBanks. The flexibility of the FHLBank model has allowed for adaptation over time in response to changing financial industry conditions and market environments.

Recognizing that there would be very serious legislative efforts to reform regulation of the GSEs and that there was a great likelihood that the Federal Home Loan Banks would be included in this legislation, in October 2003 the Council adopted "Guiding Principles" for legislative reform. With respect to the Federal Home Loan Banks, we believe that these same principles still hold true in the 110th Congress:

First, it is critical that the legislation preserve the FHLBanks' mission of providing cost- effective funding to members for use in housing finance and community development; encouraging regional affordable housing programs, which creates housing opportunities for low- and moderate-income families; and supporting housing finance through advances and mortgage programs.

Second, it is critical that the legislation provide for a strong, independent regulator. This regulator should be protected by Congress, as other bank regulatory agencies have been – such as OTS and OCC –from intervention by any other agency on policy, rulemaking, application, adjudicative and budget matters. The new regulator must be given all of the authority and regulatory tools necessary to ensure that FHLBank advance and mortgage programs can operate going forward in a safe and sound manner that is consistent with their mission.

Third, it is critical that the legislation preserve the role and function of the FHLBanks' Office of Finance. The legislation must ensure that neither the U.S. Treasury, nor the independent GSE regulatory unit, has the ability to impede or limit the FHLBanks' access to the capital markets without cause.

Fourth, it is critical that the legislation maintain the unique characteristics of the regional structure of the twelve FHLBanks and provide a regulatory structure designed to recognize these unique characteristics. The legislation should maintain the devolution of governance powers to the individual FHLBanks' boards of directors.

Beyond these principles, there are a few specific issues I would like to address with respect to H.R. 1461.

Deputy for Housing Mission Oversight – Possible Unintended Consequences for FHLBanks

The inclusion of the FHLBanks under the Deputy Director of FHERA for housing appeared in the Chairman's print shortly before the committee markup in the 109th Congress. As a result, this aspect of the legislation has not been the focus of any hearings, testimony, or input. We think that it certainly deserves close scrutiny.

The deputy for housing will be responsible for oversight over Fannie Mae's and Freddie Mac's "housing mission and goals" and oversight over "the housing mission" of the FHLBanks. Combining the housing mission oversight of the FHLBanks and Fannie Mae and Freddie Mac does not reflect the unique benefits of each and may, inadvertently create homogenized regulation and programs.

Just as FHLBank corporate operations and business models are totally different from Fannie and Freddie, the FHLBanks AHP and CIP programs are different. Our suggestion is that FHLBanks should be removed from this provision. If the Deputy for

Housing regulates the AHP and CIP, we are concerned that a national "one size fits all" approach could prevail. This would undermine one of the key strengths of the AHP, its flexibility and ability to serve housing needs in every region in the country.

FHLBank Involuntary Mergers Should Hinge on Safety and Soundness

Section 26 of the Federal Home Loan Bank Act (Bank Act) authorizes the regulator, "Whenever [it] finds that the efficient and economical accomplishment of the purposes of this chapter will be aided by such action.... Any Federal Home Loan Bank may be liquidated or reorganized [12 U.S.C. 1446]." Section 206 of H.R. 1461 would have amended section 26 of the Federal Home Loan Bank Act to provide explicit authority for the *voluntary* merger of FHLBanks and established a clear set of procedures and rights for all the stakeholders of the FHLBanks in liquidation resulting from safety and soundness problems in Subtitle C of Section 1 – Prompt Corrective Action (PCA). We support these provisions. However, the bill does not change the authority of the regulator to reorganize a Federal Home Loan Bank based simply on efficiency.

We would recommend that the committee amend Section 206 of HR 1461 to clarify that FHLBanks can only be subjected to *involuntary* reorganization for reasons related to safety and soundness under the GSE regulator's PCA authority. Any non-voluntary reorganization would have to be based upon a determination by the regulator that this drastic action is necessitated by the safety and soundness of a particular Bank or the safety and soundness of the system as a whole.

Additional Issues

The Council supports the elimination of director compensation caps that was included in the GSE reform legislation (H.R. 1461) passed by the House in the last Congress. In addition the Council supports Section 204 of H.R. 1461, which allows any two or more FHLBanks to establish a joint office for the purpose of performing functions for, or providing services to the Banks. The Council also supports the increase in the asset size for community financial institutions and the use of advances for community

development activities that was included in Section 208 of H.R. 1461. Finally, in the event that the legislation does not provide for the appointment of independent directors, the Council believes that it is important from the perspective of good corporate governance to provide for a category of independent directors, including community interest directors, and a process for their selection.

Conclusion

The Council of Federal Home Loan Banks supports legislative efforts to achieve a world class regulator for the housing GSEs. From the point of view of the FHLBanks, we believe it is critical that such legislation preserve the mission of the FHLBanks, provide for a strong, independent regulator, preserve the funding for the FHLBank System and preserve the unique regional cooperative nature of the FHLBank System.

Mr. Chairman, thank you for the opportunity to address the Subcommittee on this important matter. I will be happy to answer questions at the appropriate time.

Testimony of John M. Robbins, CMB, Chairman

Mortgage Bankers Association

Washington, D.C.

before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

Hearing on

"Legislative Proposals on GSE Reform"

March 12, 2007

Chairman Kanjorski, Ranking Member Pryce and Members of the Subcommittee, my name is John M. Robbins, and I am Chairman of the Mortgage Bankers Association.[1] I also serve as Co-Head and Special Counsel to American Mortgage Network which is a subsidiary of Wachovia Bank. Thank you for the opportunity to testify before you today as you develop legislation to reform the nation's regulation of the Government Sponsored Enterprises (GSEs), including Fannie Mae and Freddie Mac as well as the Federal Home Loan Banks.

I have been in the mortgage lending business for more than 35 years and my companies have transacted business with both the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Association (Freddie Mac) on a daily, if not hourly, basis. Other companies in the Wachovia family of companies have long been members of the Federal Home Loan Bank System. In my official capacity at MBA, I have worked with representatives of lenders of all business models and sizes from across the nation to develop MBA's policies on GSE oversight reform.

Before I begin, please let me say, Mr. Chairman, that MBA particularly appreciates your commitment and leadership in moving GSE legislation forward and making it a priority of this Committee. MBA also appreciates the dedication of the Ranking Member and the other members of this Subcommittee in this Congress, and in the last one, who worked on this legislation and also made it a high priority of this Committee. This legislation is a first priority of MBA and the mortgage industry and MBA will do all it can to assist your work.

I. INTRODUCTION AND SUMMARY

MBA strongly supports the vital role that Fannie Mae and Freddie Mac play in maintaining and improving liquidity and stability in the secondary mortgage market. MBA also strongly supports the vital role that the Federal Home Loan Bank System plays in providing liquidity to the primary mortgage market and supporting the demand for mortgages through advances by the FHLBanks to their members.

As you are well aware, all of these enterprises are exceedingly important to this nation's economy, the lending industry and families in America, whether they are homeowners

---

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

or renters. All of these enterprises are government sponsored, but in speaking of them today, I will use the term GSEs when I am referring to Fannie Mae and Freddie Mac and, when I refer to the Federal Home Loan Bank System, I will use the term FHLB System or FHLBanks.

It has been four years since accounting irregularities made weaknesses in the regulation of the GSEs clear to the general public. But for those who have worked closely on GSE regulatory issues, weaknesses in GSE oversight have been evident for a much longer time. Now that we know the many areas that need improvement, we are impatient to get the job of legislative improvement done and to get it done right. The GSEs and the FHLBanks also have indicated that they support reform of their oversight to put behind them a difficult and unhappy period in their distinguished and successful histories.

A key reason for the Great Depression and other economic catastrophes in the nation's history was a lack of liquidity for lenders across the nation. The establishment of the GSEs and the FHLBanks by Congress has proven to be a key element in rectifying this problem. Congress first chartered Fannie Mae, then the FHLBanks, and later Freddie Mac, to assure that liquidity in the housing financing market would be available to all areas and communities.

The GSEs' Charters seek to assure that the enterprises provide stability and ongoing assistance to the secondary market by increasing liquidity and improving the distribution of investment capital. The FHLBanks are cooperatively owned wholesale lending institutions that provide funds to their members at lower rates.

In order to carry out their secondary market functions, both GSEs receive significant explicit and implicit public advantages, including exemptions from certain state and local taxes, lines of credit with the U.S. Treasury and extraordinary borrowing advantages in the capital markets resulting from their public ties. The FHLBanks also benefit from a variety of statutory advantages.

As a result of their public missions and benefits, the GSEs provide the mechanism for lenders to fund mortgages through the GSEs' portfolios or their mortgage securities programs. They currently provide a secondary market and mortgage financing for mortgage lenders for an estimated $3.5 trillion in loans, approximately 70 percent of the single family conforming loans in the nation, that is those that are below the current limit of $417,000, and an estimated 45 percent of the nation's overall mortgage market. The combined portfolios of the enterprises are estimated to exceed $2 trillion. Their combined outstanding debt is only slightly less than that of the United States Treasury.

While the GSEs' share of the market has declined in some areas recently, their market shares remain staggering. The scale of the Federal Home Loan Bank System lags the total of both of the GSEs but it is massive, too. The total consolidated obligations of the FHLBanks are just under $1 trillion and their member institutions hold over $600 billion in advances from the FHLBanks.

Because of their sheer size and the need to assure that the GSEs do not present a risk to the economy at large or to the mortgage finance system, in particular, the need for a world class financial regulator for these enterprises, with strong powers to assure that the GSEs remain safe and sound, is incontrovertible. Notwithstanding the hard work of the Office of Federal Housing Enterprise Oversight (OFHEO), it lacks some of the powers of other financial regulators. We need to be certain that legislation truly rectifies this problem going forward.

At the same time, the need to assure that the GSEs carry out their charter purposes and statutory responsibilities and do not stray beyond them is equally incontrovertible. Today's mortgage market is highly competitive and comprised of thousands of largely private industry firms of all shapes and sizes.

Firms in the primary mortgage market make loans to borrowers. The GSEs and other investors operating in the secondary market purchase loans from the primary market and thereby provide a ready source of funds so lenders can lend to consumers. The new GSE regulator must assure that the GSEs are carrying out their secondary market functions and assisting, but not harming the work of, the primary market. Although the Department of Housing and Urban Development (HUD) has worked hard at mission regulation of the GSEs, it has had even fewer resources and less direction than OFHEO to carry out its functions.

While the private securitization market has grown rapidly, the GSEs still are key participants in the mortgage market. If properly regulated and harnessed, the GSEs' power, fueled by their public advantages, can do all that needs to be done to respond appropriately to the primary market, so the primary market can provide families the credit that they need. If not effectively regulated, the GSEs can use that same power to unfairly distort the market by forcing primary market players out and taking the business for themselves.

The particular structures of Fannie Mae and Freddie Mac can be useful but also can create clear conflicts. The GSEs combine the advantages of government sponsorship with the functional organizations of shareholder-owned corporations. This structure, without effective, independent oversight of the GSEs' activities, invites conflict between the GSEs' public purpose goals and their corporate goals of maximizing returns to their shareholders.

For all of these reasons, MBA believes that regulation of the GSEs must be carried out by a strong, independent and well-funded entity with the resources and expertise to evaluate the GSEs' performance, both as financial institutions and as public purpose entities.

In this testimony, MBA will describe the primary and secondary markets and provide data on their scope. MBA will then outline our specific views to improve mission

regulation as well as safety and soundness regulation of the GSEs and the Federal Home Loan Bank System. Some of the key points include:

- Respecting charter mission regulation of the GSEs, the regulator should be empowered to ensure that both ongoing and new activities are consistent with the GSEs' secondary market purposes and applicable law and that the GSEs do not enter the primary market themselves. MBA's longstanding view is that Congress should ensure that the regulator understands the distinction between the primary and secondary mortgage markets. Legislation must provide the regulator authority to review all GSE activities to ensure they are consistent with these requirements and to effectively review all new undertakings to assure that they are in the public interest, are authorized, are safe and sound and do not distort the competitive landscape of the primary mortgage market.

- MBA believes the affordable housing goals should be maintained but refocused on the housing needs of lower-income borrowers. Direction should be given so that the goals are high enough to cause the GSEs to stretch their reach into underserved markets, but realistic enough so the goals do not cause market distortions. Since the goals should facilitate liquidity, the regulator should be given discretion to determine whether the GSEs should be allowed goals credit for particular types of mortgage purchases such as senior tranches of mortgage-backed securities (MBS).

- MBA believes that if an Affordable Housing Fund is established, it must be designed so that it is not ultimately a tax on consumers or lenders. The GSEs' regulator should be empowered to assure the proper use and administration of funds. An advisory board of industry practitioners should be established to assure that funds are spent appropriately.

- MBA does not support the proposal to expand the definition of high-cost areas for purposes of the conforming loan limits. MBA does not believe "jumbo loan" borrowers need GSE funding. MBA also is concerned that such an expansion may make it more difficult for the GSEs to meet their affordable housing goals.

- MBA supports efforts to empower the regulator, on par with modern U.S. bank regulators, to carry out every aspect of sound regulation. MBA believes that the regulator should have flexibility to set and adjust capital requirements. It is important that the regulator be empowered to intervene in the event of financial distress.

- MBA does not support embedding limits on the GSEs' portfolios in statute, but instead supports conferring sufficient flexibility on the regulator to act to the extent necessary. MBA's approach would permit the regulator to ensure that the GSEs' actions do not jeopardize the system without impairing liquidity in the mortgage market.

- MBA also opposes ending the GSEs' exemption from Securities Exchange Commission (SEC) registration for MBS. MBS registration could hinder the to-be-announced (TBA) MBS market.

- MBA supports establishment of a single regulator to oversee Fannie Mae, Freddie Mac and the Federal Home Loan Bank System. MBA strongly believes, however, that the new regulatory structure must reflect the fact that the FHLBank System is fundamentally different from Fannie Mae and Freddie Mac and provide a separate division for FHLB regulation. Any new law should also expressly authorize securitization of mortgages by the FHLBanks and continuation of their Affordable Housing Program (AHP). Both of these actions will benefit consumers.

Together the secondary and primary mortgage markets have offered the needed financing to provide homeownership and affordable rental opportunities across the nation, which has been a driving force in establishing communities, creating financial stability and wealth for consumers and fueling the overall economy. Improved regulation of the GSEs, including the Federal Home Loan Bank System, if properly done, will help assure the vitality and the robust, competitive nature of both the primary and secondary mortgage markets for years to come.

II. THE PRIMARY AND SECONDARY MARKETS

A. America Has Two Residential Mortgage Markets

America's mortgage market is divided into two components. One is the primary market, the other is the secondary market. In the primary market, consumers and apartment owners consult retail lenders and mortgage brokers to learn about the types of mortgage loans available, decide which loans meet their needs, apply for and then ultimately enter into mortgage loans. The lender or mortgage broker takes and processes loan applications and obtains supporting information, such as employment and income information, property appraisals and credit histories. If approved or underwritten by a lender, based on the information developed, the lender agrees to make a loan to the consumer or apartment owner, funds it, and closes the loan. This process, beginning with the borrower's first interest in a loan through and including funding and closing of the borrower's loan, is called loan origination. Loan origination and its related activities are the work of the primary market. Notably, the primary market functions with an enormous array of originators, private companies that are extremely competitive.

The other market, the secondary market, is quite different from the primary market. One very significant difference is that the secondary market does not involve mortgage consumers or apartment owners, only mortgage purchasers or investors and mortgage lenders. There is no loan origination in the secondary market. The secondary market is where investors buy and sell loans that are originated in the primary market.

Both markets are necessary. The reasons we need the primary market are plain; consumers and apartment owners need mortgage financing and originators in the primary market are the loan sources that borrowers work with to get it.

The need for the secondary market is just as important though not as obvious. Lenders use cash to originate loans, and they often need to sell closed loans to replenish their cash so they can make more loans. The greater a lender's ability to sell loans, the greater the lender's ability to originate them. At the same time, the secondary market functions well because it is liquid; institutional investors can readily buy and sell loans.

The secondary market includes private and public investors and government sponsored enterprises including the GSEs and wholly owned government corporations such as the Government National Mortgage Association (Ginnie Mae). Increased competition in the secondary market has made the pricing of primary market mortgages more competitive, resulting in lower costs to borrowers.

The GSEs have two principal businesses. Both Fannie Mae and Freddie Mac buy loans and securities for their own portfolios. They also sell their guarantee of repayment for mortgage backed securities. The GSEs securitize loans by bundling or pooling loans together and using the loans as collateral to back mortgage-backed securities (MBS). The GSEs sell the MBS to investors. As consumers across America make payments on their mortgages, those payments pass through to these investors. In exchange for the fee that lenders pay, Fannie Mae and Freddie Mac guarantee to MBS investors that the investors will be paid, even if consumers default on their loans.

MBS are a means of participating in the mortgage market through a liquid investment. From a cash flow standpoint, investing in MBS is roughly equivalent to investing in the aggregate of mortgage loans directly. But the MBS investor buys a share in a pool of loans, and does not buy interests in the loans directly. Investment in MBS allows investors to diversify their risks across a pool of loans so that any individual problem loan will have less impact on the MBS investor.

While there is and always has been an interface between the primary and secondary markets – lenders after all sell their loans to investors and must meet their standards – the statute and the regulator must assure that both markets can continue to operate effectively in their spheres.

B. Market Data and Information – Primary and Secondary Mortgage Markets

The most recent data on mortgage loans made by lenders in 2004 and 2005 provided under the Home Mortgage Disclosure Act (HMDA) demonstrate the greatest and widest availability of mortgage finance in our nation's history. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an array of credit opportunities.

Homeownership is near its highest level in history. As a result, Americans are building tremendous wealth. According to the Federal Reserve's Flow of Funds data, the value

of residential real estate assets owned by households has increased from $10.3 trillion in 1999 to $20.4 trillion as of the third quarter of 2006, and aggregate homeowners' equity now exceeds $10 trillion. According to the Fed's 2004 Survey of Consumer Finances, the median net worth for homeowners was $184,000. For renters, it was $4,000. Clearly, many homeowners have been successful in accumulating wealth, both by steadily building up equity through their monthly payments, and through the impressive rate of home price appreciation we have seen in recent years.

More than a third of homeowners, approximately 34 percent, own their homes free and clear. Of the 66 percent of the remaining homeowners, 75 percent have fixed rate mortgages and only 25 percent have adjustable rate mortgages (ARMs). Many of the borrowers with adjustable rate loans have jumbo loans,[2] indicating that they are wealthier.

There were approximately 15 million mortgage originations in 2005, based on HMDA data, that were worth a total of $2.8 trillion. Approximately $10 trillion in residential mortgage loans were outstanding at the end of 2006. This enormous amount reflects an increase from $5.1 trillion at the end of 2000, and $2.6 trillion outstanding in 1990. In 2006, there were $33 billion in multifamily property loan originations.

The confluence of several factors has contributed to the growth in credit opportunities for mortgage borrowers over the last 15 years. These factors include innovations in the mortgage market, resulting in the range of mortgage products available today including fixed-rate products and adjustable rate products as well as the "nontraditional."[3] They also include increased competition from an unparalleled number of loan originators including mortgage companies, banks, credit unions and mortgage brokers.

8,853 lenders reported under HMDA last year.[4] These lenders employ a half million workers nationwide to meet borrowers' credit needs. An estimated 2670 lenders originated multifamily loans.

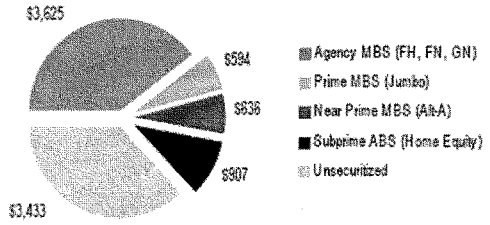
---

[2] Jumbo loans are loans that exceed the conforming loan limit, currently $417,000 for single family properties.

[3] Under the Federal Regulators' Nontraditional Guidance, nontraditional products include mortgages that may involve the deferral of principal and/or interest including interest only and payment option mortgages. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

[4] Banks that are exempt from HMDA reporting and Regulation C include institutions with less than $35 million in assets, are not in the home lending business or have offices exclusively in rural (nonmetropolitan) areas. Mortgage companies are required to report unless they extend less than 100 purchase or refinance loans a year or do not operate in at least one metropolitan area.

The components of the secondary market for mortgages are illustrated in the following chart:



Source: Bear Stearns, LoanPerformance, Freddie Mac, Fannie Mae, Ginnie Mae, Inside Mortgage Finance

The secondary market is made up of the following.

Fannie Mae and Freddie Mac currently guarantee MBS valued at approximately $3 trillion. Fannie Mae and Freddie Mac can only buy and securitize residential loans that meet charter act eligibility standards as to loan size and loan-to-value ratio. There are virtually no restrictions on the multifamily loans that the GSE may purchase. Fannie Mae and Freddie Mac maintain a very large presence in the secondary market. As indicated, they purchase or securitize approximately 70 percent of the single family conforming mortgage loans in the United States. Their share of the market for multifamily loans in 2005 was 27 percent.

Private-label MBS issuers, which are non-GSE securitizers, such as lenders and dealers, issued more than half of the mortgage-backed securities in 2005 and 2006, outpacing the GSEs. Private label issuers generally do not guarantee their MBS but publicly offered securities are subject to rating and senior investors receive a variety of other sources of credit enhancement. The loans backing private label MBS are typically ineligible for GSE purchase. Loans that are too big for Fannie Mae and Freddie Mac to purchase (jumbo loans), as well as subprime, low documentation, and other non-conforming mortgages are securitized by these issuers. In 2006, over $1.1 trillion in private-label MBS was issued, including jumbo, nonprime, Alt A, and other nonconforming mortgage products.

Government National Mortgage Association (Ginnie Mae) securitizes FHA-insured, Rural Housing Service (RHS) and Department of Veterans Affairs (VA) guaranteed residential and multifamily mortgage loans. Currently the outstanding balance of these securities is approximately $412 billion.

Federal Home Loan Banks hold government loans and conventional, conforming residential loans in the approximate amount of $98 billion. Like Fannie Mae and

Freddie Mac, the FHLBanks have portfolios and they invest in Ginnie Mae, GSE and non-agency MBS.

Whole loan portfolio investors, including thrifts, banks, pension funds, and insurance companies, hold unsecuritized loans, both residential and nonresidential, for their own portfolios. The whole loan market is approximately $3.4 trillion today.

III. IMPROVEMENT OF THE GSES' MISSION AND SAFETY AND SOUNDNESS REGULATION IS NECESSARY

MBA regards the imperative of assuring the safety and soundness of the GSEs, on the one hand, and assuring that the GSEs carry out their public missions, on the other, as necessary prerequisites of each other. If the GSEs are not safe and sound, they cannot carry out their missions. If they fail in carrying out or go beyond their missions, no matter how safe and sound they might be, they will not perform their functions and distort the competitive landscape of the mortgage market.

MBA, therefore, believes that the essential components of a new regulatory paradigm are first and foremost the establishment of a new single regulator, independent from the appropriations process. The regulator then must be given strong powers to address current weaknesses in GSE regulation to protect the safety and soundness of the enterprises and to assure that the GSEs fully achieve but do not go beyond their public purposes and applicable law. The regulator must also be given the flexibility to move quickly and nimbly to carry out these purposes as described in this testimony.

The regulator must have the authority to assure that the GSEs' purposes are performed through new program review authority, general regulatory authority, authority to establish and enforce the housing goals, fair lending and reporting requirements as well as all other mission related authorities.

The GSE regulator should have the same enforcement tools the banking agencies have for all of its functions. Among these is cease and desist authority. Cease and desist authority is one of the most fundamental, effective, flexible, and important tools a financial regulator can have. Regulators can narrowly tailor cease and desist orders to resolve a particular problem, without otherwise limiting or interfering with the institution's operations. Assuring flexibility in cease and desist orders makes them effective.

IV. THE GSEs' MISSION REGULATION IS ESSENTIAL TO THE MORTGAGE MARKETS AND MUST BE IMPROVED

The GSEs' Charters specify the purposes of the enterprises including: (1) providing stability in the secondary market for residential mortgages; (2) responding appropriately to the private capital market; (3) providing ongoing assistance to the secondary market for mortgages (including activities relating to mortgages on housing for low and moderate income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments

and improving the distribution of investment capital available for residential financing; and (4) promoting access to mortgage credit throughout the nation including by increasing liquidity and improving the distribution of investment capital available for residential financing. [5]

The Charters and current law, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA), detail the GSEs' authorities and establish prohibitions against certain activities including the direct origination of mortgage loans.[6] FHEFFSA also establishes the GSE affordable housing goals, fair lending and reporting obligations of the GSEs.

MBA strongly believes that any new regulator must have sufficient authorities and powers to assure that the GSEs carry out their purposes and perform their statutory functions including enforcement authorities. The following describes MBA's views on certain of the GSEs' functions as well as its views concerning other mission related matters including the possible prohibition of the GSEs' purchases of senior tranches of MBS secured by hybrid ARM or other loans, establishment of an affordable housing fund and expansion of the conforming loan limits for high-cost areas.

A. Assuring Charter Compliance for the GSEs' Ongoing Activities and Review of New Programs

An essential part of regulating Fannie Mae and Freddie Mac is monitoring the GSEs' adherence to their Charters and assuring that the GSEs carry out their secondary market functions. HUD is charged with that task today, but like OFHEO, it lacks some of the most basic tools to do the job.

HUD is empowered to exercise "general regulatory power" to ensure that FHEFSSA and the purposes of the GSEs' charters are accomplished.[7] HUD reviews "new programs" of the GSEs.[8] However, the specific provisions regarding new program review are constrained by a rigid time frame and unclear statutory review standards. HUD has the same amount of time to review all new programs – the same amount of time, no matter how simple or how groundbreaking the program might be.

The current definition of a "new program" effectively limits the programs subject to review and the standard of review does not allow HUD to reject a program unless it can demonstrate that it is unauthorized under broad authorities or the program is "not in the

[5] 12 USC 1716, 12 USC 1451 note. The Fannie Mae Charter includes a fifth purpose concerning managing and liquidating federally owned mortgage portfolios in an orderly manner.

[6] Section 304(a)(2)(B) of the Fannie Mae Charter, 12 U.S.C. 1716,; Section 305(a)(5) of the Freddie Mac Charter,12 U.S.C. 1451.

[7] Sec. 1321 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA), 12 USC 4541.

[8] Sec.1322 of FHEFSSA, 12 USC 4542.

public interest." The current law also does not allow HUD to reject a program application on safety and soundness grounds. It is not clear to what extent the regulator may review and order a stop to ongoing activities that are outside of the GSEs' Charter. To carry out all these functions, HUD's budget has been woefully inadequate. MBA supports legislation to address all of these matters.

Congress chartered Fannie Mae and Freddie Mac and conferred substantial public benefits on them including exemption from certain state and local taxes and a line of credit with the Treasury to do their jobs. Most other companies, banks, thrifts, and other lenders are chartered or created by a federal or state authority, not by Congress and do not enjoy these same advantages. Because of their public benefits and ties, the GSEs are able to undercut the prices of others in the marketplace.

For all of these reasons, the GSEs are subject to Congressional oversight. For the same reasons, they should be subject to strong regulatory review with clear guidance from Congress to assure that they perform their missions and do not deviate from them at the cost of the private market.

Notably, the GSEs at times have encroached upon the private market, to the detriment of competitors and competition. In recent years HUD, for example, required Fannie Mae to cease its real estate owned (REO) management and disposition activities because those activities are beyond the GSE's charter. Those activities interfered with private market competitors who offer the same services.

MBA's longstanding view is that Congress should ensure that the regulator understands the distinction between the primary and secondary mortgage markets. The regulator should be given clear direction to review all GSE programs, products and activities to assure they are consistent with the GSEs' charters and applicable law. The regulator must be empowered to effectively review all new undertakings to assure that they are in the public interest, are authorized, are safe and sound and do not distort the competitive landscape of the primary mortgage market.

Giving clear direction to review the GSEs' activities and establishing standards for such review regarding existing and new programs would provide more than mere clarity. It would go a long way to assuring competition in the future in both the primary and secondary markets.

We would add, however, that MBA supports the ability of the GSEs to innovate to carry out their charter purposes. Such innovation is vital to the primary mortgage market. The new regulatory requirements must recognize this point and assure that the GSEs are able to make technological improvements within their sphere in a timely manner.

Finally, there are a number of ways to assure that the GSEs' purposes are carried out. Whatever means is chosen, the accompanying legislative history should make clear that Congress intends that these authorities indeed be fully carried out and that no negative

inference should be gleaned from Congress's decision not to pursue any previous formulation of these authorities in earlier versions of this legislation.

B. Affordable Housing Goals

Fannie Mae and Freddie Mac must also meet affordable housing goals that Congress mandated in 1992. In establishing these goals, Congress did not expand or alter the GSEs' secondary market role. Rather, Congress clarified the GSEs' obligations to carry out their purposes of serving the primary market by purchasing, in the secondary market, their fair share of mortgage loans made to finance homes including those for low-income families and in underserved areas.

Fannie Mae's and Freddie Mac's affordable housing goals are a key part of the GSEs' role in the secondary mortgage market. MBA wholly supports the GSEs' efforts to help finance affordable housing. MBA believes the goals should be high enough to cause the GSEs to stretch their reach into underserved markets, but that the goals should be reasonable, to avoid market distortions or other adverse unintended consequences. Congress should not give the regulator authority to set an unlimited number of goals and subgoals.

MBA believes that Congress should retain the existing housing goals, but should amend them to provide greater focus on the housing needs of lower income households. MBA also believes that it is important to focus on what activities count toward the goals and support, for example, the view that loans that lenders have to repurchase from the GSEs should be subtracted from the goals-eligible loans at the time of the buyback.

C. Goals Credit for GSE Purchases of Senior Tranches of MBS Secured By Hybrid ARMs

MBA is aware of recent testimony by consumer advocacy organizations before the Senate Banking Committee concerning nonprime lending, to the effect that the GSEs' purchases of senior tranches of MBS securitized by nonprime hybrid ARMs – specifically 2-28 and 3-27s – should not count toward the goals. These organizations assert that these products are harmful to nonprime borrowers because payments increase after their initial fixed payment periods of two to three years. MBA strongly disagrees. MBA has consistently pointed out that these products are useful affordability options for mortgage borrowers including those in the nonprime mortgage market.

Under current law, HUD establishes guidelines to measure the extent of compliance with the goals which may assign full credit, partial credit or no credit toward achievement of the goals to different categories of mortgage purchases.[9] Under a new law, the Director should exercise this authority considering the value of these and other products to homeownership, as well the extent to which purchases of senior tranches of these and other securities add to liquidity and otherwise meet the objectives of the

---

[9] Sec. 1336 of FHEFSSA, 12 USC 4566

goals.

D. Affordable Housing Fund

Some have suggested that, in addition to retaining the affordable housing goals, Congress should require the GSEs to contribute to a fund to assist lower income families in obtaining affordable housing. While several proposals have been offered on how to calculate the contribution, MBA has concluded that any contribution should be calculated as a percentage of outstanding GSE debt. This approach would help avoid making the fund a tax on consumers or lenders. It would also tie the contribution to a benefit of government sponsorship, the GSEs' lower capital costs. Notably, the same amount of contribution can be required under this calculation method as any other method.

To assure that the funds actually go toward meeting the affordable housing needs for which they are intended, the GSEs' regulator should have authority to determine by regulation how the funds are used and to monitor their administration. An advisory board of industry practitioners should be established assure that funds are spent appropriately. If the funds are distributed by a formula to state or local agencies to administer, MBA recommends that a process similar to that used for HOME[10] funds be employed so that both cities and states receive an allocation and have the ability to target the funds to areas of greatest need.

E. Expansion of High-Cost Areas and Ceiling Increases for GSE Eligible Loans

In the last Congress, Representative Gary Miller (R-CA) introduced an amendment to expand the number of high-cost areas for purposes of the GSE conforming loan limits beyond those currently in place. Currently, the nationwide conforming loan limit for loans eligible for GSE purchase for securitization or for their portfolios is $417,000 for a single family home. Under the GSEs' Charters, this limitation may be increased by up to 50 percent to $625,500 for properties located in Alaska, Hawaii, Guam and the Virgin Islands.

To respond to the increased housing costs of recent years, the Miller Amendment would have allowed access to GSE financing for mortgages in additional high-cost "areas." The term "areas" was not defined in the legislation but many assumed it to mean Metropolitan Statistical Areas (MSAs).

MBA does not support this amendment. We respectfully ask the Committee to consider the following points.

If such an expansion were imposed today, there would be few new high-cost areas under an MSA approach based on higher housing costs. Today, if MSAs were used to define new high-cost areas only twelve MSAs would likely be added as new high-cost

---

[10] HOME Investment Partnerships Act, 42 USC 12701 note.

areas.[11] All of those MSAs are located in California, the New York metropolitan area and the Washington, D.C. metropolitan area.[12]

While MBA opposes the addition of new high cost states as unwarranted, use of ZIP codes, census tracts or a county-based system would present operational difficulties and increase loan costs to borrowers.

Ordinary arithmetic suggests that if the GSEs are able to purchase additional mortgages, it will be more difficult for them to satisfy percentage based affordable housing goals

In 2006, the private mortgage market funded over $500 billion in jumbo mortgages, ineligible for GSE purchase, for borrowers in all sectors of the market, prime and nonprime, in all states, utilizing fixed-rate and adjustable-rate mortgages. MBA is unaware that any jumbo borrowers faced any obstacles to obtaining this financing.

The difference in the mortgage rate between a conventional, conforming mortgage and jumbo mortgage ordinarily ranges between one-eighth of a percent and one-quarter of a percent for a fixed-rate mortgage, or less. There is frequently no difference in the mortgage interest rate for an adjustable-rate mortgage.

The percentage of borrowers qualified for a mortgage above the GSE ceiling limit of $417,000 comprises a very small percentage of the population. In order for a borrower to qualify for a mortgage of $625,500, the borrower would ordinarily need to earn an income of at least $170,000.

---

[11] We are using data furnished by the National Association of Realtors, one of the few sources of relatively current housing prices. The data is current through September 2006.

[12] The proposal previously introduced would have allowed the high-cost area limits to be above the GSE ceiling limits by the lower of the median housing cost level in the "area" or 150 percent of the GSE ceiling limit. That maximum, based on this year's GSE ceiling limit, would be $625,500 for a single-family home. Only one MSA in the country has a median housing cost at or above that amount and most of the new high-cost areas would be eligible for a new ceiling vastly lower than the 150 percent high-cost maximum.

If the MSA approach were rejected, an alternative would be the current approach of identifying states (Hawaii and Alaska) or similar types of jurisdictions (Guam and the Virgin Islands). According to the most recent statistics published by the Federal Housing Finance Board for purchase prices by state, however, only three jurisdictions have median purchase prices above the GSE loan ceiling: Hawaii ($454,200), the District of Columbia ($504,000) and California ($516,700). It is not evident that simply adding these jurisdictions as high-cost areas would meet the goals of the advocates of the proposal.

V. SAFETY AND SOUNDNESS OF THE GSES IS IMPORTANT TO THE MORTGAGE MARKETS

The GSEs must act in a safe and sound manner to perform their secondary market functions, including meeting their affordable housing goals.

America has seen growth in the value of its housing stock, and this is a source of wealth for the more than two-thirds of American families who now own homes. As the homeownership rate and our population have grown, the need for responsive housing finance has increased accordingly. As technology has advanced and as refinancing has become easier, the equity Americans have in their homes has become more liquid. Homeowners' ability to tap their equity has been a major engine for economic growth.

Our housing finance system, made up of both GSEs and private companies, requires access to liquid funds day in and day out from both American and international capital sources. The housing GSEs are major links between the capital market and the housing market.

Regulating the safety and soundness of two firms as big and as complex as Fannie Mae and Freddie Mac is extremely challenging. For this reason, MBA believes the safety and soundness regulator should have all the tools necessary for the task. The regulator needs general regulatory authority, which OFHEO currently lacks. The regulator should have enforcement authority on par with that of the banking agencies.

Further, MBA believes the GSE regulator's budget should be funded through assessments on the regulated entities outside the appropriations process, as bank regulators are funded. An insufficient budget, pressured by the constraints of appropriations, as well as regulatory weaknesses have been a serious impediment to Fannie Mae's and Freddie Mac's regulators over the years.

A. Capital Regulation

It is important that Fannie Mae and Freddie Mac maintain capital levels that support liquidity for the residential mortgage markets and that are also consistent with safety and soundness, stability for the overall market, and minimum exposure to the American taxpayer. Some have proposed that the regulator's capital authority should permit the regulator to require capital increases only in a narrow set of circumstances. MBA does not share that approach. MBA believes the regulator should have flexible authority to set appropriate capital standards.

Today, Freddie Mac's and Fannie Mae's capital surcharge is required through OFHEO's cease and desist authority, not its capital authority. OFHEO's cease and desist authority is flexible and can address many problems, not just capital deficiencies. If the regulator's capital authority is limited, it is possible that some might construe the capital

authority as limiting the regulator's cease and desist authority. It is important that Congress be careful not to inadvertently limit the regulator's cease and desist authority.

B. Receivership

Congress has debated whether to include provisions that would permit a regulator to appoint a receiver if either Fannie Mae or Freddie Mac were to become financially distressed. MBA's view is that in the unlikely event of distress at either company, it is important to maintain the operations of mortgage finance markets. MBA believes this should be the fundamental principle behind any receivership provisions.

MBA does not believe the regulator should appoint a receiver or conservator lightly. Rather, the regulator should only be able to appoint a conservator or receiver when there is a serious capital deficiency, a serious threat to liquidity, or a real possibility of market disruption.

When a regulator does need to intervene, it should be able to operate the enterprise to restore it to health if that would best protect the housing markets. If necessary, the regulator should be able to maintain the operations of the mortgage securitization business, which is critical to the markets, while winding down the portfolio operation in an orderly manner. Because it may be necessary for a GSE in receivership to issue debt to ensure an orderly wind-down of the portfolio business, the receiver should of course have the authority to cause the GSE to issue debt to ensure that orderliness.

To ensure certainty in the markets today, before there is a problem, Congress should specify a priority of claims in the event either Fannie Mae or Freddie Mac is in receivership. Congress should specify that holders of MBS that the GSE had issued have a prior claim to the mortgages backing the MBS, as well as to the flow of revenue the GSE continues to receive as guarantee fees. That guarantee fee revenue would be necessary for the securitization business to continue. The securitization business is critical to market function, and Congress should ensure its continuation even if Fannie Mae or Freddie Mac were in receivership. This would help maintain the operations of the mortgage finance markets, which should be the underlying policy for any Congressional action in this area.

Only Congress, not the regulator, should be able to rescind a GSE's charter.

C. Portfolio Restrictions

During discussions of regulatory improvements, it has been suggested that Congress should place strict limits on the size of Fannie Mae's and Freddie Mac's portfolios of mortgage loans and MBS due to risks arising from the portfolios.

While MBA is supportive of efforts empower the regulator to protect against financial risks presented by the GSEs, MBA does not believe that a Congressionally mandated dollar cap or limit on the GSEs' portfolios would be the best method of protecting

against such risks. The mortgage and financial markets fluctuate and evolve. In 2006, for example, the market shrank and the GSEs' portfolios shrank in part due to changing market conditions, and in response to increased regulatory capital requirements. A rigid dollar cap on the GSEs' portfolios would not have adjusted to these changed circumstances.

The GSEs' portfolios can provide liquidity and stability in times of market turmoil. For example, in 1998 when many financial markets were in turmoil due to the Russian debt crisis combined with the collapse of Long Term Capital Management, the GSEs' ability to rapidly expand their portfolios helped maintain stability in the mortgage market. A hard-wired portfolio limitation could interfere with this important function.

The portfolios also help the GSEs meet their affordable housing goals. Special loan structures enable many lower income families to purchase homes. And, there are unique characteristics of single-family reverse mortgages for the elderly making them difficult to securitize. Both Fannie Mae and Freddie Mac purchase a significant number of single-family and multifamily loans that are not easily securitized for their portfolios and these purchases make a critical contribution to the GSEs' ability to meet their goals. A rigid portfolio limitation could interfere with this important source of financing for affordable homes for lower income Americans. Finally, by financing their portfolios, the GSEs also have attracted significant foreign capital to the American mortgage markets, allowing the U.S. housing market to grow. This function should be preserved.

While the MBA does not support the establishment of arbitrary limits on the GSEs' portfolios, this does not mean that it supports unchecked portfolio growth. The regulator should be authorized to assess the risks in each GSE's portfolio and the degree to which the portfolio supports the GSE's secondary market and affordable housing mission. Based on this analysis, the regulator should be empowered to design appropriate means for limiting the risks of the portfolios considering current financing needs.

D. GSE Exemption from SEC Registration

The GSEs' Charters contain specific exemptions from Securities and Exchange Commission (SEC) registration. In response to a considerable degree of pressure, the GSEs agreed in July 2002 to register one class of their common stock under Section 12 (g)[13] of the Securities and Exchange Act of 1934 (the '34 Act or the Exchange Act). Pursuant to the Exchange Act's reporting requirements, the GSEs agreed to file annual, quarterly and current reports updating their financial material which will be subject to SEC review and comment.

---

[13] Under Section 12(g), an issuer that is exempt from the 1934 Act can register its stock with the SEC. Once an issuer submits to the registration and reporting requirements, it can opt to discontinue that status only under very limited circumstances. For practical purposes here, it is a permanent election.

The issue is whether this voluntary filing is sufficient, or whether the GSEs' SEC exemption should be eliminated and the GSEs should be required to fully register their debt, equity and MBS issuances. There appears to be no adverse impact to the housing finance system, nor significant additional burden to the GSEs, of requiring Fannie Mae and Freddie Mac to register either their non-MBS debt or their equity securities under the Securities Act of 1933 and the Exchange Act of 1934. However, MBA believes the statutory exemption for MBS issued by the GSEs should be preserved.

GSE MBS is traded through pools with specified characteristics and through trades of MBS of a generic nature, not yet identified. These generic MBS are traded in the to-be-announced, or TBA, market. The TBA market has numerous uses for the mortgage industry, including dollar roll hedging, without the intent to take control of the actual collateral, reference pricing, purchasing collateral for future structured transactions, and other purposes. One problem with SEC registration for GSE MBS is that TBA securities could not comply with the rigorous disclosure regime required under the SEC's Regulation AB because actual information is not available for these issuances prior to purchase.

A second concern is that there would be significant transaction delays caused by the SEC process. According to 2004 testimony by the SEC, the timing of transactions could be affected.[14]

A third problem with bringing GSE MBS under SEC registration is that the lenders who sell their mortgages in return for MBS could be viewed under the securities laws as underwriters with underwriter liability. All of these factors will converge to make GSE executions more expensive and impede a market which is working very well.

At the same time, it does not appear that investors would gain much by virtue of registration of GSE MBS. Investors already have distinctive safeguards with GSE MBS for several reasons:

- Fannie Mae and Freddie Mac mortgage securities almost always include a *corporate guarantee* that principal and interest will be paid in the manner described and principal will be repaid;

- Fannie Mae and Freddie Mac remain engaged in their transactions in significant roles, including as trustee, master servicer, and guarantor; and

- Fannie Mae and Freddie Mac are responsible under the terms of their agreements to assume servicing responsibilities in the event of a default and to assure that the loans are serviced as agreed.

---

[14] See testimony of Alan Beller, Director, SEC Division of Corporate Finance, before the Committee on Bank, Housing and Urban Affairs, United States Senate, February 10, 2004. www.sec.gov/news/testimony/ts021004alb.htm

VI. IMPROVEMENTS TO THE REGULATION OF THE FEDERAL HOME LOAN BANKS

The FHLBanks have a distinctive structure and an important housing role.

MBA strongly supports the FHLBanks and their advancing, mortgage and affordable housing programs. Several hundred of our member companies are members of FHLBanks and, for many of those institutions, their largest single investment is their stock in their FHLBank. Appropriate regulation of the Federal Home Loan Bank System is critical to our members and to the continued support of housing provided by the FHLBanks. MBA suggests the following be considered in establishing improvements to the regulation and oversight of the FHLBanks.

A. Any New Regulatory Structure Should Recognize the Distinctive Nature of the System

The Federal Home Loan Bank System has a major presence in global capital markets with $934 billion of consolidated obligations outstanding. The proceeds of those obligations are used to fund the $641 billion in advances outstanding to member institutions and to fund portfolio investments. The advances are collateralized and the collateral is largely residential mortgage loans. Through their advancing programs, the FHLBanks stimulate demand for mortgage loans and provide funds for them.

In addition to supporting community institutions by providing low-cost advances, the FHLBanks' advancing program supports housing. This support comes from the requirement that advances be collateralized, and almost all of that collateral is residential, single-family mortgage loans.

The FHLBanks, with assets of $1.02 trillion as of December 31, 2006, support housing in other ways as well. For example, they held over $100 billion in Fannie Mae, Freddie Mac and non-agency MBS at the end of 2005. The FHLBanks also held approximately $9 billion in debt of Fannie Mae, Freddie Mac, and state and local housing agencies. Finally, the Banks hold approximately $98 billion in residential mortgages through their MPP and MPF programs.

The FHLBanks differ from the other two GSEs in many ways, including some of the following major respects:

- **Structure**: Fannie Mae and Freddie Mac are shareholder-owned and publicly traded corporations. The Federal Home Loan Banks comprise a system of 12 institutions, each covering certain states and each cooperatively owned by member institutions in those states.

- **Profit Motivation**: As cooperatively owned institutions, the FHLBanks' primary focus is member service through their programs and, therefore, their businesses are less focused on maximizing profits than the other GSEs.

- **Membership Value:** Members receive dividends from the FHLBanks as well as beneficial advancing rates and the right to participation in the FHLBanks' mortgage purchase and affordable housing programs.

- **Scope of Mission:** The FHLBanks primarily support residential housing but they are also empowered to support economic development, including commercial, industrial, manufacturing, social service, and other projects.

Accordingly, any new regulatory structure should reflect the fact that the FHLBank System is fundamentally different from Fannie Mae and Freddie Mac. Some of the bills introduced in previous Congresses have recognized this distinction to a greater or lesser degree. While MBA supports establishment of a single regulator to oversee Fannie Mae, Freddie Mac and the Federal Home Loan Bank System, a separate division should focus on the FHLBanks.

B. Securitization Authority Should Be Made Explicit

In addition to their advancing programs and the collateral required to be held, the FHLBanks support housing through the billions of dollars they hold as investments in GSE mortgage-backed securities and in residential, single-family mortgages purchased through their Mortgage Purchase Program (MPP) and Mortgage Purchase Finance (MPF) programs. While these programs have shrunk in recent years to approximately $98 billion, they remain valuable to the mortgage market to a greater extent than their dollar volume might indicate. They provide important competition to the programs of the other GSEs.

The Federal Housing Finance Board has expressed concerns about the FHLBanks holding mortgages on their balance sheets. From a safety and soundness perspective, the primary tool to manage these assets would be securitization of these loans. However, concerns have been expressed that the FHLBanks may not have the authority to do so.

While MBA believes that the Federal Home Loan Bank Act conveys adequate authority in this area, MBA thinks it would be useful to add clarifying language to the statute for this purpose. Securitization would further increase competition in the secondary market benefiting home loan borrowers and renters with lower costs.

C. The FHLBanks' Affordable Housing Program Should Be Preserved

As a result of the FHLBanks' Affordable Housing Program, the Banks collectively are the largest donor organization to affordable housing in the nation. The program functions well, it achieves its purpose and is well administered. Considering that the FHLBanks are doing their share to support affordable housing, MBA does not believe that further intervention, such as attaching goals to eligible collateral or making the FHLBanks subject to other goals is necessary.

VII. CONCLUSION

The Mortgage Bankers Association appreciates the opportunity to present its views on these important issues. MBA will do all it can to help the Congress move forward to develop, and we

hope shortly enact, effective, comprehensive, GSE legislation to provide effective safety and soundness and mission regulation for the GSEs and the FHLBanks.

NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

500 New Jersey Avenue, N.W.
Washington, DC 20001-2020
202.383.1194 Fax 202.383.7580
www.realtors.org/governmentaffairs

Thomas M. Stevens, CRB, CRS, GRI
President

Dale A. Stinton, CAE, CPA, CMA, RCE
EVP/CEO

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Walter J. Witek, Jr., Vice President

HEARING BEFORE THE

HOUSE FINANCIAL SERVICES COMMITTEE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

ENTITLED

LEGISLATIVE PROPOSALS ON GSE REFORM

WRITTEN TESTIMONY OF THOMAS M. STEVENS, CRB, CRS, GRI 2007 IMMEDIATE PAST PRESIDENT

NATIONAL ASSOCIATION OF REALTORS® MARCH 12, 2007

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

Chairman Kanjorski, Representative Pryce and Members of the Subcommittee, thank you for inviting me to testify today. My name is Tom Stevens, and I am the 2007 Immediate Past President of National Association of REALTORS®. I am also the former President of Coldwell Banker Stevens (now known as Coldwell Banker Residential Brokerage Mid-Atlantic) – a full-service realty firm specializing in residential sales and brokerage.

I am here to testify on behalf of our more than 1.3 million REALTOR® members who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors and others engaged in all aspects of the real estate industry. Members belong to one or more of some 1,400 local associations/boards and 54 state and territory associations of REALTORS®. Fannie Mae and Freddie Mac are partners in the housing industry and as such, I appreciate the opportunity to share our views on the issues involved in legislative proposals designed to strengthen the regulation of the housing government-sponsored enterprises (GSEs) and the Federal Home Loan Banks.

It has been almost two years since REALTORS® testified before Congress on the issue of improving the regulation of the housing GSEs. When we first testified on this issue, the subject was still new; various issues had yet to be considered or debated; and some ideas that had been discussed were quite controversial. While there was a considerable amount of activity in the 109th Congress, it unfortunately adjourned without enacting a GSE reform bill. It is our understanding that at the end of the 109th Congress, Chairman Frank, then ranking member of the House Financial Services Committee, worked with Treasury to negotiate a compromise proposal, some provisions of which may be included in forthcoming legislation.

NAR did not take a public position on any of the particular compromise provisions that were reported in the media and I do not attempt to do so today. Instead, my remarks will focus on six elements which we believe are important to address in GSE reform legislation. They are:

1. Strong regulator and GSE governance;
2. Housing mission;
3. New program approval;

4. Separation of mortgage origination and the secondary market ("bright line");
5. Portfolio limits; and
6. Conforming loan limits.

As we testify today, we eagerly await new draft legislation which will create a strong regulatory regime that preserves the housing mission of the GSEs and strengthens the nation's housing finance system.

Strong Regulator and GSE Governance

Over the last two years, a general agreement on the basic framework for a new GSE regulatory structure has evolved. That consensus strongly suggests that the current regulatory responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO), the Department of Housing and Urban Development (HUD), and the Federal Housing Finance Board should be transferred to a single, independent safety and soundness regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. This new housing enterprises regulator should have the authority to set capital standards; liquidate a financially unstable enterprise through a conservator or receiver; and approve new programs and products. The Federal Home Loan Banks should be regulated under the same framework, with due concern for cooperative ownership by member financial institutions. There is also general agreement that Fannie Mae and Freddie Mac affordable housing goals should be refined.

NAR supports strengthening financial soundness regulation for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks through an independent regulatory agency. Having independent, expert financial oversight will enhance confidence in the nation's housing finance system. This new regulator should have the appropriate authority and resources to oversee safety and soundness of the GSEs. The regulator also should understand and support the GSEs' vital housing finance mission and the role that housing plays in the nation's economy and public policy.

NAR also supports a continued independent, public voice in the corporate governance of the GSEs. We believe that the board of Fannie Mae, Freddie Mac and the Federal Home Loan Banks should be well balanced in knowledge and expertise in the full range of GSE-related issues and activities. NAR supports the legislative efforts to address concerns regarding the governance of the Federal Home Loan Banks by enhancing the Banks' direct role in selecting board members, raising the number of independent directors, adding community and economic development expertise, and allowing appointed independent directors to continue their service until a successor is in place.

Housing Mission and the Secondary Mortgage Market

Congress chartered Fannie Mae and Freddie Mac with advantages unavailable to commercial banks and other financial institutions. Fannie Mae and Freddie Mac enjoy lower funding costs, the ability to operate with less capital, and lower direct costs. These advantages were and are an integral component of the GSEs' public policy mission. The advantages of GSE status have helped the secondary mortgage market grow and provided much needed stability to our nation's housing financial system.

Very simply, Congress created Fannie Mae and Freddie Mac to do what no fully private company could or was willing to attempt. Unlike private secondary market investors, Fannie Mae and Freddie Mac remain in housing markets during downturns, using their federal ties to fulfill their public purpose obligation to facilitate mortgage finance and support homeownership opportunity.

In their own ways, each of the housing enterprises have used their federal charter advantages to meet their missions. The "mechanism that widens the circle of ownership," as one observer defined the secondary mortgage market, is dynamic, robust and continually evolving – all to the benefit of mortgage originators, home buyers, and other industry participants.

The broad expansion of homeownership, mortgage markets, as well as the related rapid growth of the GSEs has also had another effect. Financial services providers, many of which compete

with Fannie Mae and Freddie Mac, now question the GSEs' activities, function, and the continuing need for their government-chartered status. These financial companies argue that Fannie Mae and Freddie Mac have an unfair advantage because of their federal charter ties. Yet these same lenders' parent banking companies have their own federal subsidies that come in the form of deposit insurance and other benefits derived from the nation's banking and financial system safety net.

REALTORS® believe that the GSEs' housing mission, and the benefits that derive from it, play a vital role in the continued success of our nation's housing system. We have opposed and will continue to oppose legislative proposals that would reach beyond safety and soundness regulation and diminish the housing mission of the GSEs.

New Program Approval

Currently, Fannie Mae and Freddie Mac cannot initiate a new program without first obtaining the approval of HUD. When GSE reform was considered in the 109th Congress, the issue of program approval, specifically the limitations of the current statute, was widely debated. NAR believes that any legislative proposal that attempts to address the program approval process should not include new regulatory requirements that could unduly delay or prevent the GSEs from developing new programs and products that support their missions.

For example, such authority should not undermine secondary market innovations based on Fannie Mae and Freddie Mac credit risk management technologies. These innovations assure a smooth supply of reasonably priced mortgage credit and allow homebuyers to manage their interest rate risk when locking loans rates and terms before closing.

NAR believes that whatever approach Congress takes to address the shortcomings of the current statutory framework, the result must be flexible to promote product and program innovation and allow for prompt responses to housing market needs.

Separation of Mortgage Origination and Secondary Market

REALTORS® recognize and support the role that program, business and activity approval may have on the financial safety and soundness of the GSEs. However, not every new activity of the GSEs should be subject to an extended regulatory public comment process. This requirement could directly damage the GSEs' housing mission, and stifle innovation and programs that would help Americans achieve the dream of homeownership.

In the 109th Congress, one legislative proposal that NAR cautioned against was the "bright line" regulation, which would have distinguished mortgage origination from GSE secondary market activities and imposed restrictions on Fannie Mae and Freddie Mac mission-related activities. One "bright line" proposal would have specifically prevented the GSEs from directly or indirectly participating in mortgage origination and may have required Fannie Mae and Freddie Mac to divest themselves of their automated underwriting systems, upon which many banks rely.

REALTORS® oppose overly restrictive "bright line" legislative proposals that explicitly limit GSEs business to the secondary markets, strictly defined. It would instantaneously preclude many of the GSEs' existing products and activities that were designed to increase access to mortgage credit, lower the costs of homeownership, and foster innovations in home financing.

For example, the "bright line" provision would seriously hinder (and possible prohibit) the array of mission-related, consumer outreach activities by lenders and housing counselors that are supported by the GSEs. The GSE-designed counseling and education programs that help lenders, mortgage brokers, REALTORS®, and housing counseling agencies determine a consumer's financial readiness for homeownership are technically on the "wrong side" of the "bright line" and would be prohibited.

This is just one example of the negative impact such a standard would have on critical components of the housing market. REALTORS® urge you to reject the rigidity and arbitrariness of a statutory "bright line" test.

Portfolio Limits

One of the most widely debated issues has been the size of the portfolios currently held by the GSEs and whether the portfolios contribute to the GSEs' mission. Then Federal Reserve Board Chairman Alan Greenspan was one of the most vocal advocates of legislative proposals to shrink the size of the GSEs' retained portfolios. Chairman Greenspan and others have argued that the size of the portfolios, together with the perceived incentives for the GSEs to pursue portfolio growth, increase the possibility of GSE insolvency and destabilization of our nation's financial markets.

Significantly, those advocating retained portfolio limitations do not identify any immediate systemic financial risk. Viewed strictly from a systemic risk perspective, GSE retained portfolios, just like the portfolios of the 5 largest banks in the U.S., are vulnerable to interest rate changes and could pose a risk to taxpayers should the enterprise or the bank become insolvent or improperly hedge risk. Without more information, we do not see a need to impose a systemic risk test on the GSEs that would not also apply to the largest FDIC insured banks.

REALTORS® also oppose rigid statutory limits on the GSEs' portfolio size. Instead, we believe a better legislative approach would be to create a sufficiently strong regulatory authority over capital that would limit portfolio risk and may also moderate portfolio growth, when appropriate.

While it is obviously important to consider the safety and soundness implications of GSE portfolio size and the associated risks, we would ask that the Congress not ignore the advantages that portfolio holdings and size have on mission-related activities and housing markets. The GSEs point out that the returns earned on retained portfolios help support the enterprises' affordable housing programs and also contribute to the availability of financing for low-income borrowers. For example, Freddie Mac reports that approximately $300 billion of the mortgages in their retained portfolio qualify under the affordable housing goals.

Simply stated, REALTORS® oppose portfolio limits imposed just for the sake of shrinking the GSE mission. Portfolio limits should not be prescribed in statute. Instead, we believe the

portfolios should be regulated by the GSEs from a risk perspective, and the regulator should determine if one or both of the GSEs' retained portfolios affect safety and soundness.

Conforming Loan Limits

Fannie Mae and Freddie Mac are currently limited by imposed statute to only purchasing mortgages that are within a cap that is determined based on an annual survey of house prices and applied nationally. The 2007 national cap of $417,000 is well above the national median sales price of $219,300[1] for single family homes and exceeds the local median for the majority of housing markets. However, the 2007 national cap is considerably below the local median in the nation's largest high cost metropolitan areas.

NAR supports regional adjustments to conforming loan limits for high-cost areas as a matter of simple equity for American families in these markets. Regional adjustments will help working families in high-cost areas qualify for conforming GSE loans. It will also expand access to FHA and VA mortgages, since both FHA and VA loan limits are tied to the conforming ceiling. Veterans, teachers, firefighters, and police officers are examples of working families who stand to benefit. Access to safe and affordable mortgages is especially important for first-time homebuyers. Regional limits also help existing, middle income homeowners move into more suitable homes to accommodate growing families. By making it more affordable for homeowners to move up the housing ladder, regional adjustments will also help make more affordable homes available for first-time homebuyers.

Limited regional adjustment authority will enable the GSEs to purchase relatively few additional total mortgages from only a few high-cost areas. According to a 2005 study we commissioned to evaluate the impact of cap adjustments on the market, the number of conforming purchase money loans purchased by the GSEs would have increased by 2.3% nationally. Additionally, based on NAR's Survey of Existing Home Sales for the 4th quarter of 2006, only seven

[1] Based on 4th Quarter 2006 NAR Survey data.

metropolitan statistical areas will be affected.[2, 3] Such an adjustment would not change the GSE goals for low- and moderate-income housing.

NAR also believes that regional adjustments to conforming loan limits for high cost areas would give homebuyers access to safer mortgages, which is especially important for first-time homebuyers. Borrowers in high cost markets such as California currently account for a disproportionate share of interest-only and option ARM mortgages. HMDA data show that in many high costs areas FHA-insured mortgages are practically nonexistent and the GSE share of the market is shrinking significantly. Greater access to GSE, FHA, and VA mortgages will help promote homeownership in a safer, more sustainable way.

Finally, there is precedent for regional adjustments for high cost areas. In 1980, Congress designated Alaska, Hawaii, Guam, and the U.S. Virgin Islands as high cost areas. The conforming loan limit in these statutory high cost areas is 50 percent higher than for the rest of the nation, but housing prices in these areas are no longer uniquely high. In fact, housing prices in several high cost areas now exceed those in Honolulu. NAR urges Congress to include in any GSE reform legislative proposal the authorization for regional adjustments to the national conforming loan limits for high-cost areas.

Conclusion

The National Association of REALTORS® shares the belief of our industry partners that Fannie Mae, Freddie Mac and the Federal Home Loan Bank System are integral components of this nation's highly acclaimed housing finance system. Home buyers depend on the secondary mortgage market to supply a continued and stable source of funding for single-family and multifamily housing.

---

[2] MSAs Affected in 2007 by Regional Adjustments: NY-Northern NJ-Long Island, NY-NJ-PA; Bridgeport-Stamford-Norwalk, CT; Washington-Arlington-Alexandria, DC-VA-MD-WV; San Francisco-Oakland-Fremont, CA; Los Angeles-Long Beach-Santa Ana, CA, San Jose-Sunnyvale-Santa Clara, CA; and San Diego-Carlsbad-San Marcos, CA.

[3] Two markets in each of three states—California, Florida, and Massachusetts—would have benefited from regional conforming loan limit authority in 2005 when the national limit was $359,650. Several of these are within 10% of the current $417,000 limit: (a) the Boston-Cambridge-Quincy, MA-NH MSA has a median sales price of $388,000, and (b) the Riverside-San Bernardino-Ontario, CA MSA has a median sales price of $406,400.

NAR believes GSE reform legislation should be principally focused on safety and soundness regulation and should protect Fannie Mae's and Freddie Mac's abilities to accomplish their housing mission. We hope that Congress can reach a consensus on GSE reform, so that all in the housing industry can focus our efforts on increasing affordable homeownership opportunities, especially among minorities and other underserved populations.

The National Association of REALTORS® pledges to work with the 110th Congress to enact GSE reform legislation that achieves our mutual goals and protects the vibrancy, liquidity and evolution of the housing finance system.

Testimony of the
American **Bankers** Association

Submitted for the record

before the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the
Committee on Financial Services
United States House of Representatives

Regarding Legislative Proposals on Government Sponsored Enterprise Reform

March 12, 2007

The American Bankers Association is pleased to submit testimony for the record regarding legislative proposals on Government Sponsored Enterprise (GSE) reform. The ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of our industry. Its membership - which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks - makes ABA the largest banking trade association in the country.

Our Association has long supported reforming the regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. We were strong supporters of legislation passed on a bi-partisan basis by this Committee and the House of Representatives in the last Congress. We appreciate the efforts of this subcommittee and the Financial Services Committee to again address the need to create a strong, reliable, and coherent supervisory structure for

these GSEs. This testimony will address the financial implications of GSE reform for the banking industry and the need for a new regulatory structure. The ABA has developed a number of principles relating to GSE reform that we would like to share with you. In addition to these principles, we shall also address some specific policy issues that have arisen with regard to ongoing reform efforts.

Financial Implications for the Banking Industry

Fannie Mae, Freddie Mac and the Federal Home Loan Banks combined have approximately $2.6 trillion in debt. This compares to $5.4 trillion in total corporate debt in the U.S. economy and approximately $4.3 trillion in Treasury debt. The banking industry holds a significant amount of GSE debt. Combined GSE debt and GSE-sponsored mortgage backed securities (MBS) held by the banking industry represent 11.26 percent of total assets of the industry. Significantly, combined GSE debt held by the banking industry equals 141 percent of the tier one capital held by the entire industry: because GSE debt represents such a large component of the nation's economy, and such a large portion of bank holdings, strong, reliable and coherent supervision of the GSEs is vital.

Principles on GSE Reform

ABA has developed the following principles which we believe should guide any reform of GSE regulation:

- Any new GSE regulatory agency should be an independent agency within the Treasury Department. The agency should be modeled on other Treasury regulatory agencies, and should not be reliant upon the appropriations process for funding.

- Any new agency with oversight of Fannie Mae and Freddie Mac should have authority to regulate mission adherence, product approval, and safety and soundness of these enterprises. Establishment and review of specialized affordable housing goals should be done in consultation with the Department of Housing and Urban Development.

- The new agency should not impede the enterprises' access to the capital markets beyond the current authority of the Treasury Department to regulate "traffic flow" to the markets.

- Any new agency must take into consideration the considerable differences among the GSEs, and particularly with regard to the Federal Home Loan Banks, that there are significant differences between the FHLBs and Fannie and Freddie with regard to their missions, their lines of business, and the customers they serve. These differences must be reflected in the organizational structure and the regulatory agenda of the new agency.

Specific Policy Issues

Product Approval: It is vital that any legislation contain clear, unambiguous and sensible requirements for approval of products offered by the GSEs. Such language must ensure

that the GSEs remain secondary market providers and that they do not stray into the primary market through the development of new products or services. At the same time, it will be important that product approval procedures do not inhibit innovation or development of secondary market products that enhance and assist primary market participants and consumers. We recognize that there can be a very fine line between a primary and secondary market activity, and that evolving marketplaces can sometimes blur even that fine line. Therefore, we encourage the inclusion of language in any legislative proposal requiring, as a foundation for product approval, that any product must adhere strictly to the GSEs' charter limitations.

Capital: ABA has long advocated for bank-like regulation of the GSEs, particularly with regard to the required capital levels. We note that banks, on average, hold approximately six percent capital. Currently, the Federal Home Loan Banks hold approximately four percent capital and Fannie and Freddie hold approximately 2.5 percent (with an ongoing regulatory requirement that Fannie and Freddie each hold 30 percent additional capital above the 2.5 percent limit due to consent decrees entered into by each GSE). While differences in the percentage of capital held may be appropriate, depending upon the risks faced by differing entities, we maintain that the way the risks are determined and the levels that are set should be similar. Bank regulators are in the process of considering ways to improve the risk sensitivity of their capital rules, and we believe that a similar process should be undertaken for the GSEs. Although some have raised concerns about capital levels being used by a regulator to achieve policy goals other than those related to the safety, soundness and mission of the GSEs, we believe that a strong, respected regulator, like the banking regulators, would have strong institutional biases against using capital levels for other

purposes. Creating a strong, independent regulator with powers like those given to the bank regulators will help to ensure the proper actions by both the regulator and the regulated.

Mission: Our principles for reform include taking into consideration the differences among the GSEs. These differences include structure (Fannie and Freddie are publicly held corporations while the Federal Home Loan Banks are member-owned cooperatives), and differences in mission. While all three entities were created to serve the primary market, the Federal Home Loan Banks' mission is far different from that of Fannie Mae and Freddie Mac. Therefore, we strongly urge that the organizational structure of the new regulator take into account this difference in mission as well as the differences in structure and ownership. Additionally, we would note that the Federal Home Loan Banks' mission includes the funding of the Affordable Housing Program, a highly successful and innovative program that has provided billions of dollars in grant and other assistance to foster the development and preservation of affordable housing nationwide. Care must be taken to ensure that nothing is done either in legislation or through a new regulatory scheme to harm this successful program.

Farm Credit System: Finally, ABA urges the Committee to use this opportunity to review the regulatory oversight of a GSE which all too frequently escapes serious regulatory scrutiny – the Farm Credit System (FCS). The FCS is a multi-billion dollar entity whose regulator lacks the financial expertise of the Treasury Department. It is notable that the FCS is the only GSE which has required federal intervention to prevent a financial default. Clearly it is an entity that would benefit from a regulator with greater expertise and supervisory powers. We recognize that the FCS is not under the jurisdiction of the Financial

Services Committee, but we urge the committee to work with the Agriculture Committee to bring more appropriate regulatory oversight to this often overlooked GSE.

Conclusion

The ABA strongly supports efforts to reform the regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. We encourage the committee to incorporate our guiding principles relating to the structure, mission and powers of the new regulatory agency. We appreciate this opportunity to comment on reform proposals, and we will be pleased to work with the committee as the legislative process moves forward.

On behalf of the Asian Real Estate Association of America (AREAA), I applaud you for your leadership in promoting more affordable housing and equal access to homeownership for low- and moderate-income and minority families.

AREAA is dedicated to closing the homeownership gap facing the Asian and Pacific American (APA) community. Currently, Asian American homeownership level is approximately 60%, which is about 15% points below that of non-minority community. AREAA members are real estate and mortgage practitioners focused on serving the growing base of Asian American and immigrant homebuyers. Currently, we have over 6,000 members in nearly 30 States.

The housing GSEs play a critical role in providing liquidity, stability and affordability to the housing market. It is also important to recognize that the GSEs receive a set of special benefits that they derive from their Congressional status, and therefore, more is expected of those enterprises compared to other financial institutions. Indeed, AREAA firmly believes that the GSEs should lead the industry in creating innovative lending products and offerings to better support the growing first-time buyers as well as the burdening number of minority and immigrant families that are reshaping this country's cities and towns. Additionally, there is a tremendous need for the GSEs to find new and better ways to serve consumers that are faced with interest rates resets and ballooning mortgage payments. GSEs must take a leadership role in creating sustainable solutions for these growing number of borrowers faced with dire economic situations.

Over the past several years, there have been a significant debate and discussions about the appropriate oversight powers of the GSE regulator. We believe that it is critical that the legislation help to restore market confidence and create a safety and soundness regime worthy of the important role that the housing GSEs play in the real estate market. Additionally, we believe that need for affordable housing is great in this country and we must enhance some of the affordable housing mandates without damaging the agencies' underlying economic viability.

As Congress considers various proposals to retool the GSE regulatory regime, we must ensure that the underlying strength of the housing system is not compromised. As Congress takes actions related to the GSE safety and soundness enhancements, we need to ensure that the GSE capital requirements are consistent with the risk they are taking as an institution but without creating unnecessary burden on the capital structure.

Not enough capital can undermine market confidence and long-term viability of the institutions; however, excessive capital levels that stifle innovation in lending for low-income as well as minority and immigrant families will be counter to their mission. Under the context of a strong regulatory regime, the GSEs should have sufficient business and operational flexibilities to prudently deploy their resources in support of affordable housing and mission whether through their retained portfolio or guarantee business.

Loan Limits

Because a high percentage of APA community live and work in high cost areas, AREAA supports increasing the conforming loan limits for the GSEs. By increasing the loan limits in those areas, APA housing consumers will be able to obtain a lower interest rate on their loans and, therefore, increase their ability to purchase a home. In high cost states, such as California where only 14 percent of homes are affordable to average income families, even a small reduction in the interest rate can be significant and will help more APA families obtain their dream of homeownership.

Affordable Housing Fund and Foreclosure Prevention

Since the GSEs and FHLBanks have a special status and benefits that they derive from their Congressional charters, AREAA believes that there is an added responsibility on these institutions to do more for minority and first-time homebuyers than what would be expected from other financial institutions. AREAA supports the idea of the Housing Trust fund and believe that one of the eligible activities of the fund should be to help minority and first-time homebuyers through innovative programs. We believe that these funds could be managed by the GSEs (as it is the case with the FHLBanks) or through a national intermediary that can disperse these funds to local nonprofits, affordable housing providers, local governments and other institutions focused on sustained homeownership and affordable housing developments. Additionally, AREAA supports the Congressman Frank and Senator Reed's proposal to require significant percent of their profits to go towards these important affordable housing activities.

Additionally, AREAA supports a set-aside for loss mitigation and foreclosure prevention activities from the fund. Foreclosures are becoming a wide-spread concern among policy makers, advocates and industry players alike. Unfortunately, there are limited public and private resources dedicated to curb delinquency and foreclosure. Given the proliferation of aggressive mortgage products over the past several years and the slow-down in the real estate market, AREAA is concerned that marginal borrowers, particularly minority and first-time homebuyers, will be disproportionately impacted by these issues. The progress this country has made towards increasing minority homeownership over the past ten years will materially erode unless we take strong action. This fund can be one important solution to this problem.

Stronger Statutory Goals for GSEs

AREAA supports the reformulation the GSE's statutory underserved goal to reflect added focus on minority homeownership needs, first-time buyers, and to promote increased GSE activities in markets with significant high-cost lending activities. These changes will create greater incentives for the GSEs to take even more of a leadership role in lending to minorities and to promote lending innovations, such as automation of alternative credit products. Additionally, AREAA believes that there should be consistent treatment of affordable housing obligations between the two housing GSEs and the Federal Home Loan Banks where possible.

AREAA and its members are prepared to work with you to create a stronger GSE regulatory regime and to promote greater affordable housing obligations on part of these important enterprises. I thank you for your consideration of our views.

Sincerely,

Jim J. Park
President and CEO
areaa.org

National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
(703) 522-4770 • (800) 336-4644 • Fax: (703) 522-0594

B. Dan Berger
Senior Vice President
Government Affairs

March 9, 2007

The Honorable Paul Kanjorski
Chairman
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Deborah Pryce
Ranking Member
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Kanjorski and Ranking Member Pryce:

The National Association of Federal Credit Unions ("NAFCU") supports your efforts and those of your Congressional colleagues to craft a solid legislative package dealing with the critical issues in ensuring the safety and soundness of our nation's secondary mortgage market. In conjunction with Monday's hearing, I would like to share some of our thoughts on this important issue.

Homeownership is a core American value and our members are proud of the role that credit unions have come to play in recent years - in conjunction, with Fannie Mae, Freddie Mac and the Federal Home Loan Banks (collectively the GSEs") in helping an ever increasing number of Americans achieve the dream of owning their own home. NAFCU's member credit unions hold approximately 65 percent of all Federal credit unions assets. While the average NAFCU-member credit union has $341 million in assets, the median is significantly smaller with assets of $99 million.

Within the credit union community, NAFCU's membership has a vital interest in the consideration of matters related to GSE reform and in the preservation of a viable secondary mortgage market. GSEs allow credit unions to obtain the necessary capital to create new mortgages for their member-owners by utilizing the secondary market, despite the capital restrictions that are in place. Moreover, the GSEs are a key conduit for access to mortgage credit throughout the nation by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing. As of December 2006, NAFCU-member credit unions accounted for:

73.44% of all Federal credit union real estate loans;
74.51% of all Federal credit union 1st mortgage loans outstanding;
76.41% of all Federal credit union mortgages granted in 2006;
81.56% of all Federal credit unions 1st mortgages sold in 2006.

NAFCU recognizes that GSE-reform is a multi-faceted issue. In this letter, NAFCU will limit our comments to four specific issues in which our member credit unions have a particular interest: the need for an independent GSE regulator, prior program approval, limits on portfolio holdings, and minimum capital levels.

GSEs Warrant an Independent Regulator

NAFCU strongly supports the efforts to create an effective, world-class, independent regulator. However NAFCU believes that an independent regulator would need to be outside the Congressional appropriations process and, moreover, be independent of the political process. These steps are necessary to ensure that the independent regulator would be focused on the safety and soundness of GSEs. Additionally, GSEs warrant an independent regulator that would be equivalent to those of the other federal financial regulators, with the same supervision and enforcement powers. Absent an independent regulator, there will always be a danger that the GSEs will from time to time find themselves unintentionally pulled in different directions by well-intended regulators whose statutory emphasis is on different aspects of their regulatory framework.

Prior Approval of Programs, Products and Activities

Some have suggested that as part of the GSE reform process, Congress should require that Fannie Mae, Freddie Mac and the Federal Home Loan Banks submit to the new regulator for prior approval before implementation, any proposals for new and/or innovative programs, products or activities. NAFCU recognizes the vital importance of proper regulatory supervision and the need to ensure that the GSEs' programs products and activities remain mission-centric; however, NAFCU is concerned that if Congress mandates prior approval of programs, products and activities, the net result could be a stifling of creative thinking and an unintended decline in innovation. In lieu of prior approval, NAFCU recommends Congress take a more moderate approach of requiring the GSEs to submit to the new regulator, a notice of intent to implement new or innovative programs, products and/or activities, thus giving the regulator the authority to block or "veto" implementation if it is deemed unfit. Absent such a "veto," new programs, products and activities should be allowed to move forward from concept to implementation, without the need for public notice and comment and without explicit agency approval.

Limits on GSEs' Portfolio Growth and Holdings

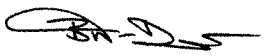
Some have advocated that hard caps be placed on the growth potential of GSEs' portfolios. NAFCU urges Congress to exercise restraint in imposing such limits. NAFCU is concerned that such hard caps would obstruct GSEs from being fully capable in fulfilling their mission and in fact, might erect unnecessary obstacles to the GSEs in ensuring that we have a strong secondary market for mortgages. Additionally, NAFCU does not support the forced or "directed" divestiture of GSEs' investments/holdings, except when deemed appropriate by the new regulator for legitimate and documented safety and soundness concerns.

Minimum Capital Levels

As congress considers the regulatory authority for the GSEs' minimum capital levels, NAFCU recommends that any changes be done solely for safety and soundness concerns. Requiring the GSEs to hold excess capital beyond what is necessary for the safe and sound operation of the enterprises will limit the liquidity that the GSEs can provide to credit unions. Because of this impact, changes to the minimum capital levels of the GSEs by their new regulator should be made cautiously and should be detached from political decisions on the role of the GSEs in the housing market. While the regulator should have discretion to change the minimum capital requirements for Fannie Mae and Freddie Mac similar to other federal financial regulators, such discretion should be limited to changes that are directly tied to specific safety and soundness concerns.

Thank you for the opportunity to share NAFCU's views on these important issues. If you have any questions or if we can be of further assistance to you or your colleagues in the consideration of matters related to GSE reform please do not hesitate to contact me or NAFCU's Director of Legislative Affairs, Brad Thaler at (703) 522-4770 ext. 204.

Sincerely,



B. Dan Berger.
Senior Vice President, Government Affairs

cc: Members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services

To strengthen and promote cities as centers of opportunity, leadership, and governance.

National League of Cities

1301 Pennsylvania Ave., N.W.
Washington, D.C. 20004-1763
202-626-3000
Fax: 202-626-3043
www.nlc.org

2007 Officers

President
Bart Peterson
Mayor
Indianapolis, Indiana

First Vice President
Cynthia McCollum
Council Member
Madison, Alabama

Second Vice President
Kathleen Novak
Mayor
Northglenn, Colorado

Immediate Past President
James C. Hunt
Councilmember
Clarksburg, West Virginia

Executive Director
Donald J. Borut

March 12, 2007

Congressman Barney Frank
2252 Rayburn H.O.B.
Washington, DC 20515-2104

Congressman Paul E. Kanjorski
2188 Rayburn House Office Building
Washington, DC 20515-3811

Dear Congressmen Frank and Kanjorski,

The National League of Cities (NLC) appreciates your leadership on issues impacting the Federal Home Loan Banks (FHL Banks). We applaud your recognition of the important contribution that Federal Home Loan Banks provide in assisting local governments meet the challenges of the day. In particular, we welcome the Financial Services Committee's oversight plan calling for examination of "efforts to advance community and economic development within the FHLB system." FHL Banks are important partners for our members as they work to meet the infrastructure and economic development needs of communities throughout America.

As your committee approaches GSE regulatory reform in the 110th Congress, all focus is rightly on building the best regulatory structure possible. The National league of Cities also believes this debate is an opportunity for Congress to review the FHL Banks' positive track record of assistance to local governments and explore ways where even greater partnership can be achieved.

FHL Banks are reliable behind-the-scenes partners for economic and community development. Their Community Investment Program (CIP) provides financing to member financial institutions for community and economic development projects that create housing, improve business districts and strengthen neighborhoods. Examples of current CIP funding include water and sewer upgrades, rural health care facilities and first responder facilities. Since these programs are operated at cost by FHL Banks, we would hope to see them continue with possible additional programs where Federal Home Loan Banks can do more in this area and their members can realize a reasonable return on their investment.

FHL Banks provide their AAA-rated letter of credit (LOC) to improve the credit rating of community lending and taxable public finance transactions. Additionally, LOCs are used to secure municipal deposits. Examples of LOC transactions include senior housing facilities, economic development financing authority bonds and hospitals.

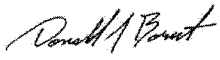
Page 2
March 9, 2007
Congressman Frank
Congressman Kanjorski

In addition, FHL Banks provide direct mission related investment to eligible projects and support small business lending through special set-asides like FHLBank Pittsburgh's Banking on Business Program.

As communities struggle with constrained federal and state funding, these programs represent welcome options for local leaders. The NLC supports efforts at the legislative and regulatory level allowing FHL Banks and their members to build on these successful partnerships with local governments and expand their impact. We are not advocating mandatory program impositions on FHL Banks. Rather we want to see a statutory and regulatory environment that will support and encourage further development of new ways to support public finance and infrastructure in a partnership with Federal Home Loan Banks, their members, and local governments.

Thank you for your attention on these issues and your continued support of issues important to the NLC. Please include this letter into the record of the upcoming hearing on GSE Regulatory Reform being held on Monday March 12, 2007 before the Capitol Markets, Insurance and Government Sponsored Enterprises Subcommittee of the Financial Services Committee.

Sincerely,



Donald J. Borut
Executive Director

Past Presidents: **Clarence E. Anthony,** Mayor, South Bay, Florida • **John DeStefano, Jr.,** Mayor, New Haven, Connecticut • **Brian J. O'Neill,** Councilman, Philadelphia, Pennsylvania ***Directors:*** **R. Michael Amyx,** Executive Director, Virginia Municipal League • **Susan Burgess,** Mayor Pro Tem, Charlotte, North Carolina • **Thomas Carlson,** Mayor, Springfield, Missouri • **Susan Cave,** Executive Director, Ohio Municipal League • **Deborah Denard Delgado,** Councilwoman, Hattiesburg, Mississippi • **Joseph Donaldson,** Mayor, Flagstaff, Arizona • **Pat Ekland,** Councilmember, Novato, California • **Ted Ellis,** Mayor, Bluffton, Indiana • **Makia Epie,** Council Member, Cedar Hill, Texas • **Margaret Finley,** Councilmember, Duarte, California • **Rene Flowers,** Councilmember, St. Petersburg, Florida • **John Franklin,** Councilmember, Chattanooga, Tennessee • **Gary Grahan,** Mayor, O'Fallon, Illinois • **Donald A. Groesser,** Mayor, Ralston, Nebraska • **Jeanne Harris,** Councilmember, Vancouver, Washington • **Dain S. Hester,** Council Member, Norfolk, Virginia • **Charles Hughes,** Councilmen-At-Large, Gary, Indiana • **Steven Jeffrey,** Executive Director, Vermont League of Cities and Towns • **Michael E. Johnson,** Council Member, Phoenix, Arizona • **Martin Jones,** Council Member, Conyers, Georgia • **Jennifer L. Kim,** Council Member, Austin, Texas • **Daisy W. Lynum,** Commissioner, Orlando, Florida • **Margaret Mahory,** Executive Director, Tennessee Municipal League • **Cynthia Mangini,** Councilman-At-Large, Enfield Connecticut • **Marcia Marcoux,** Councilmember, Rochester, Minnesota • **Henry Marraffa, Jr.,** Councilman, Gaithersburg, Maryland • **Tom Ed McHugh,** Executive Director, Louisiana Municipal Association • **Darryl Moss,** Mayor, Creedmoor, North Carolina • **James Perkins, Jr.,** Mayor, Selma, Alabama • **Daniel Pocek,** Mayor, Bedford, Ohio • **Richard Radcliffe,** Councilman, Greenacres, Florida • **Lynn Rex,** Executive Director, League of Nebraska Municipalities • **Julie Aberg Robison,** Council Member-At-Large, Cary, North Carolina • **Shirley Scott,** Council Member, Tucson Arizona • **Anne Sinclair,** Council Member, Columbia, South Carolina • **Walter Skowron,** Council Member, Loveland Colorado • **Connie Sprynczynatyk,** Executive Director, North Dakota League of Cities • **Ken Strobeck,** Executive Director, League of Arizona Cities and Towns • **Lynne Whalen,** Council Woman, Casper, Wyoming • **Lynne Whalen,** Council Woman, Casper, Wyoming • **Dennis Zine,** Councilman, Los Angeles, California

JAMES R. BIERY
President, CEO & Treasurer
Phone 717.255.6911
Fax 717.733.6362
jbiery@pabanker.com

March 9, 2007

Via Facsimile

Dear Congressman Kanjorski.

On behalf of the Pennsylvania Bankers Association (PBA) I am writing to thank you for your continued leadership on issues impacting the Federal Home Loan Banks (FHLBanks) FHLBank Pittsburgh is a member of the PBA and an important partner for our other members as they work to meet the credit needs of communities throughout Pennsylvania.

Your recent letter to the Federal Housing Finance Board in support of Federal Home Loan Bank mortgage programs will help these programs develop in a risk-managed approach to better serve our members and the homebuyers of Pennsylvania.

As the Congress approaches GSE regulatory reform in the 110th Congress, we hope to keep the focus on building the best regulatory structure possible. This debate is an opportunity for Congress to ensure the availability of FHLBank liquidity and highlight the ways FHLBanks and their members can assist local governments struggling to meet their economic and community development challenges.

Not only are FHLBanks a reliable source of liquidity for our members, but they are also a behind-the-scenes partner for economic and community development through their low interest community lending program, AAA-rated letters of credit, and direct mission related investments Eligible initiatives include water and sewer infrastructure, senior care facilities, and business lending in qualified areas.

As communities struggle with less federal and state funding, these programs represent welcome options for local lenders. PBA respectfully requests that you support efforts at the legislative and regulatory levels to permit FHLBank Pittsburgh to build on these successful partnerships with community banks and local governments and expand their impact in communities throughout Pennsylvania

Secondly, FHLBanks are unique institutions with business models and products different from those of Fannie Mae and Freddie Mac. PBA supports current House language placing their regulation under separate divisions within the new regulator Unfortunately, the legislation might also establish a third division charged with "housing mission" regulation for all three of the GSEs.

We believe that this one size fits all "mission" regulator is inconsistent with Congressional intent to recognize the FHLBanks' unique structure and could limit the flexible nature of their successful Affordable Housing Program (AHP). In addition, this arrangement could also impact the availability and economic benefit of FHLBank advances. Advances are the principal funding source for FHLBanks. They already possess efficient mission regulation through the Bank's ten percent AHP contribution.

Should FHLBanks remain under this deputy for mission regulation, Congress must ensure that the arrangement does not hinder the availability or raise the cost of FHLBank advances. Failing to do so could seriously impact the FHLBanks.

Thank you for your attention to these issues

Sincerely,

James R. Biery