

Testimony of

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Mr. Chairman, Senator Sarbanes, and Members of the Committee, I appreciate the opportunity to testify today. I appear before you in two capacities. First, I am the Chairman, President, and CEO of Thumb National Bank and Trust Company, a commercial bank in Pigeon, Michigan. Thumb National began its service to mid-Michigan as the Farmer's Bank in 1895. Both my father and grandfather served as Chairmen of the Bank, and I began work at Thumb National in 1973. We now have four locations, approximately \$180 million in assets, and 57 employees.

Second, I am Chairman of the Board of Directors of the Federal Home Loan Bank of Indianapolis. The Indianapolis FHLBank has 436 member institutions that serve communities throughout Indiana and Michigan. I have served on the board since 2003, and earlier this year, I was elected Chairman. Through the Indianapolis FHLBank, small- to medium-sized institutions like Thumb National have access to funds from the national capital markets at rates and maturities that are otherwise available only to very large banks. The member banks fund home mortgages in their communities by borrowing money from the FHLBank and increasingly by selling their mortgages to the FHLBank.

As both a representative of the Indianapolis FHLBank and as a customer of the FHLBank System, I hope to provide the Committee with my perspectives on the value of the System, including the ways it benefits small banks like mine. The FHLBank services continue to adapt to an evolving financial market to better serve its members and the communities in which they operate, such as my hometown of Pigeon. I will address the need for preserving the FHLBanks' ability to be innovative as Congress considers legislative proposals to reform the regulation of the government-sponsored enterprises ("GSEs").

Housing finance and liquidity is the mission of the FHLBanks. It is critical that Congress preserve this vital role of the System, which has been an extraordinary success for banks like Thumb National and for our customers. In recent years, one element of that success has been the mortgage purchase programs ("MPP"), which I describe below. The growth of the MPP underscores the need for clear guidance from Congress to affirm the authority of our regulator to

approve securitization by the FHLBanks. As I will explain in this testimony, securitization is vital to ensuring the continuing safety and soundness of the FHLBank System.

Value of the Federal Home Loan Bank System

The FHLBanks are cooperatively owned and controlled by member institutions in their districts. The FHLBanks support housing finance and community development by making loans, called advances, to members on the security of mortgages and other pledged collateral. These advances are particularly important to smaller community lenders that lack diverse funding sources.

I see the benefits of the FHLBank System every day at Thumb National Bank. Like other community banks across the country, we would be unable to compete as effectively with the big financial service providers without the FHLBanks. Home Loan Bank funding supplements our deposits, ensuring that the customers in our local community have uninterrupted access to funds for loans. We can offer competitively-priced home mortgage products because we have access to advances to fund the mortgages we hold in portfolio.

Our relationship with the FHLBank that supports us in this way allows Thumb National to provide highly personalized customer service with a financial product line competitive to the national providers. Without the Indianapolis FHLBank, it is not clear to me that the Village of Pigeon and Huron County, Michigan, would have the benefit of a community bank providing investment lending to its local market. We have a dedicated board and a full complement of local employees that frankly, unlike the national and regional financial providers, have no choice but to serve and continually invest dollars in our community. Our local presence is particularly important in a rural community like mine, where too many young people leave after high school or college. If we can provide more attractive opportunities for business investment, job growth, and homeownership, it will encourage our young people to stay in rural communities like Pigeon. It is critical than Thumb National, working with the Home Loan Bank, provide the capital and economic stimulus needed to develop and redevelop rural America.

Recent analytical studies reaffirm that FHLBank membership facilitates homeownership and economic development. A study by Welch Consulting (February 2005) confirms that FHLBank members have higher overall home mortgage origination rates and higher minority origination rates than do non-member financial institutions. Another study by Tuccillo, Flick and Ranville (February 2005) concludes that FHLBank members hold a significantly greater proportion of their mortgage loans, small business loans, construction and land development loans, and agricultural credit in portfolio than do non-members.

Moreover, since passage of the FIRREA legislation in 1989, ten percent of the FHLBank System's net income, including profit from the mortgage purchase programs, goes toward grants under the Affordable Housing Program ("AHP"). AHP grants support long-term lending for owner-occupied and rental housing targeted to households with very low, low, or moderate incomes. In 2004, the Indianapolis FHLBank awarded more than \$16 million through the AHP, funding over 100 projects that created or rehabilitated 2,269 homes in our region.

Value of the Mortgage Purchase Program

In 2001, the Indianapolis FHLBank launched its Mortgage Purchase Program in response to the requests of members like Thumb National Bank. Other FHLBanks have, at the discretion of their local boards, participated in similar programs since the late 1990s in response to member demand for more secondary market alternatives.

MPP is an excellent example of the FHLBank System adapting to meet its members' needs consistent with our housing finance mission. Many of the FHLBanks' smaller members knew that they were not getting competitive pricing when selling to Freddie Mac and Fannie Mae because their production was too small. Additionally, small members were often unable to offer the lowest mortgage rates to their local customers because they had no choice but to sell their mortgages to larger aggregators at unfavorable rates. Members of the Indianapolis FHLBank, regardless of size, prefer dealing with the Indianapolis Bank because they understand, as cooperative owners, profits from the mortgage purchases are returned to them in the form of

dividends. Rather than holding mortgages in portfolio, members that choose to sell their mortgages do so to free up capital so that they in turn can make more mortgages. Selling mortgages to the FHLBank also helps the member reduce its credit and interest rate risk.

Under the MPP, the Indianapolis FHLBank purchases conventional 15- or 30-year fixed-rate loans for primary, owner-occupied residences. The member institution retains a portion of the credit risk on the loans, while the FHLBank assumes some credit risk and all of the market risk related to possible changes in interest rates. Thumb National Bank has sold a number of loans to the FHLBank under this program. For us, this option makes us more competitive and benefits not only the Thumb National Bank, but also the homebuyers in our community.

Since 2001, the MPP has grown steadily in reaction to demand. Ninety-five members of the Indianapolis Bank now participate, including both large mortgage and banks from small towns in Indiana and Michigan. Nationally, the twelve FHLBanks hold \$114 billion in whole mortgage assets on their balance sheets acquired under mortgage purchase programs.

The New York FHLBank has placed a per member dollar limit on the amount of mortgages that it will purchase. The Indianapolis FHLBank does not agree that rationing this program among FHLBank members is the right solution. Market demand, subject to prudent regulatory oversight, should determine the volume of purchases under these programs. Moreover, Congress should not legislate portfolio limits. As a member of the Indianapolis FHLBank, I need to know that I can count on the FHLBank to purchase mortgages that we originate rather than be told to look elsewhere – most likely to Fannie Mae, Freddie Mac, or large mortgage aggregators. Finally, to limit the volume of mortgage purchases would naturally increase prices, as in any rationed market, to the detriment of homeowners.

The Indianapolis FHLBank has concluded that serving our housing mission with two product lines is safer for the FHLBanks and our industry than relying solely on advances. Our track record demonstrates that the purchase of conforming mortgages assists our members by

offering a competitive alternative to Freddie Mac, Fannie Mae, and other secondary mortgage aggregators.

Although some of the Indianapolis Bank's largest members are also the largest users of the MPP, their volume simply reflects their overall market share. Under the FHLBanks' enabling statute, even the smallest members receive competitive pricing. As a co-op, the economies of scale that the FHLBanks receive from the large MPP users and large advance borrowers are also passed on to small members, like Thumb National.

Need for Securitization

Just as the MPP represents a successful evolution of the FHLBanks' role in serving their members and the public, securitization is a necessary and logical step in giving the regulator the tools necessary to allow the FHLBanks to mitigate risk and ensure safety and soundness. As the mortgage programs grow, the FHLBanks cannot continue to hold all of the mortgage purchases on their balance sheets. Consistent with the mission of the FHLBanks to provide liquidity to member institutions, securitization is a needed risk mitigation tool to allow an FHLBank to better manage interest rate risk.

Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow have expressed concerns about the size of the GSEs' on-balance sheet portfolios. Securitization addresses this concern while preserving the FHLBanks' ability to serve their members through the mortgage purchase programs.

Securitization is a well-proven technique routinely and safely used by the industry. If implemented by the FHLBanks, it would increase secondary mortgage competition and lower mortgage costs for consumers. It also provides a relief valve so that each FHLBank can take all relevant factors into account in managing the size and risks of its balance sheet.

The Indianapolis FHLBank applauds the Mortgage Bankers Association for focusing the housing industry on the securitization issue. Giving the regulator the explicit authority to

approve securitization in the pending legislation is also supported by the National Association of Homebuilders. In our district, the Indiana Bankers Association, the Michigan Bankers Association, the Community Bankers Association of Indiana, and the Michigan Association of Community Bankers have all endorsed this proposal.

Most of those who oppose securitization for the FHLBanks do so in an effort to limit true competition in the secondary market for their own financial benefit. For example, there are mortgage aggregators and conduits that package mortgages from small- and medium-sized financial institutions with mortgage volume too small to get favorable pricing. The aggregators profit as a middleman by re-selling these mortgages in the secondary market – often to Fannie Mae and Freddie Mac. This leaves the FHLBanks’ smaller members at a competitive disadvantage without reliable, continuous access to the mortgage purchase programs.

Confirming Regulatory Authority

Although we believe that current law provides our regulator with authority to permit securitization, the Indianapolis FHLBank recommends that GSE regulatory reform legislation provide the regulator the explicit authority to permit the FHLBanks to securitize conforming home mortgages. This would grant the regulator the clear discretion to allow one FHLBank, several FHLBanks, or all the FHLBanks voluntarily to issue and guarantee the mortgage-backed securities.

The FHLBank regulator needs this tool to regulate the safety and soundness of the FHLBank System effectively while, at the same time, assisting the System in fulfilling its statutory housing finance and liquidity mission. The securitization program or programs should not be designed or “hard wired” by statute. Instead, the law should grant the regulator the authority, after having the opportunity for input, to approve or reject programs designed by the FHLBanks.

The Indianapolis FHLBank would be pleased to work with our regulator and other FHLBanks on a pilot securitization program. This pilot could be then tested for viability as well as safety and soundness.

Conclusion

With GSE reform legislation pending, now is the time to confirm the regulator's authority to authorize FHLBank securitization. Securitization has a well-proven track record in the financial services industry. It will enable an FHLBank to continue to provide liquidity to its members in a cost-efficient way by purchasing conforming home mortgages without keeping the interest rate risk on the balance sheet. It also allows our Bank to better manage our capital and the overall size of the mortgage portfolio. With this tool and with the approval of the regulator, securitization will allow the FHLBanks to purchase more safely and competitively conforming home loans from our members.

It is an honor to testify today. Thank you for giving me the opportunity to present the views of the Indianapolis FHLBank. I would be pleased to answer questions.