



DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS

**Embargoed Until 2:00 pm EDT
September 9, 2003**

**Contact: Betsy Holahan
202-622-2960**

**Testimony of
Wayne A. Abernathy
Assistant Secretary of the Treasury for Financial Institutions
Before the Subcommittee on Financial Institutions
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC**

Thank you, Chairman Bennett and Ranking Member Johnson and members of the Subcommittee for this opportunity to testify today on the Federal Home Loan Bank (FHLBank) System. The Department of the Treasury is keenly interested in the operations of the Federal Home Loan Bank System because of the important responsibility that the Congress has placed with the Federal Home Loan Banks to enhance the liquidity of financial institutions, particularly as the Federal Home Loan Bank members meet such important community needs as promoting home ownership.

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

The FHLBank System has had a long history of supporting housing finance in America. Congress created the FHLBank System in 1932 in response to a Depression-era liquidity crisis in housing finance. The FHLBank Act directs the FHLBanks to make loans – called advances – to eligible members. Advances traditionally served the role of providing thrifts access to reliable long-term funding for mortgage lending and as a source of liquidity to help thrifts finance deposit outflows without calling or selling their mortgages. Over time, Congress has expanded

the System's membership base beyond thrifts, but the primary function of advances has remained relatively constant. Today, financial markets and our nation's housing finance system bear little resemblance to the one that existed when the FHLBank System was created.

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

Voluntary Registration with the SEC under the 1934 Act

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

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

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

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

At the end of June, the FHLBanks had outstanding consolidated obligations of \$712 billion, of which bonds with original maturity of one year or longer constituted \$556 billion of the total.

The individual FHLBanks are each large financial institutions. As of year-end 2002, the largest Home Loan Bank (the FHLBank of San Francisco) had \$135 billion in total assets, the smallest (the FHLBank of Topeka) had \$33 billion in total assets, while the average among the 12 banks was \$58 billion in total assets. Even the smallest Federal Home Loan Bank would rank among the top 40 commercial banks in the United States.

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

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

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

Multi-District Membership, In Context

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

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

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

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

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

To say this is not to render a policy point of view. There are compelling arguments on both sides of the question with regard to the advisability of multi-district membership. Clearly our financial system has changed dramatically since the System was established in 1932 and the predecessor to the current regulator created the 12 banks, and determined their locations and boundaries. In the intervening years, however, Congress has revised the governing statutes on several

¹ 12 U.S.C. § 1424(b).

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

occasions. It is to the Congress that these arguments should be offered and where any change in the statute will have to be made.

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

Treasury's Review of the FHLBank System

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

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

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

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

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

Membership – GLBA eliminated mandatory membership requirements for Federal savings associations and permitted broader access to FHLBank membership for community financial institutions (insured depository institutions with less than \$500

million in total assets). What has been the impact of these changes in membership participation? Have those changes affected governance of the Home Loan Banks?

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

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

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

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

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

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

As another related aside, I would like to raise a point about a legislative proposal regarding the membership of privately-insured credit unions in Federal Home Loan Banks. As part of that proposal, private insurers of credit union deposits would be required to submit annual audit reports to the National Credit Union Administration (NCUA). In addition, upon the NCUA's request, the appropriate state supervisory agency would be required to provide the NCUA with examination reports of private deposit insurers. We are concerned that the provisions related to the NCUA could give the false impression that the NCUA has oversight authority over the private deposit insurers of credit unions and that the Federal Government somehow stands

behind the private insurers. Not only would that be a terribly false impression potentially harmful to depositors, but it would also remove some of the market discipline that is so essential to the successful functioning of any private insurance program.

Conclusion

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

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