

**Testimony of John T. Korsmo,
Chairman, Federal Housing Finance Board,
Before the Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C.
October 23, 2003**

Good morning and thank you, Mr. Chairman, Ranking Member Sarbanes, and distinguished members of the Committee.

In December 2001, this Committee and the Senate honored me with confirmation to membership on the Federal Housing Finance Board (Finance Board) and President Bush entrusted me with the Finance Board's chairmanship. During my confirmation hearing, both Senator Sarbanes and former Senator Gramm impressed on me – indelibly – their concern over the Finance Board's inadequate performance.

In response, I committed myself to leading the agency to fulfill the intent of Congress in FIRREA and the Gramm-Leach-Bliley Act – that is, to create a credible arm's-length regulator for the Federal Home Loan Banks (FHLBanks). So, I testify today not as an apologist for the Banks and certainly not as a partisan for the Finance Board, but rather as a safety and soundness regulator who takes seriously his oath of office and his promise to this Committee.

In that spirit, I offer today my experience as you seek to develop policy for the supervision of the nation's housing government sponsored enterprises (GSEs).

Congress and the Administration are engaged in a worthy effort to ensure proper regulation of the GSEs, and this effort, I believe, would be well served by seeking a broader context. That is, to craft an appropriate housing GSE regulator, policymakers should thoroughly consider what is to be regulated, both today and in the future. The first question to ask is what today's capital and mortgage markets look like, 70 years after the charters for housing GSEs were cast? What will these markets look like 10, 20, 30 years in the future? And what role or roles should government sponsored enterprises play in those markets?

Answering these questions I believe will require a thorough review, necessary to set the stage for a comprehensive reform debate in Congress, with participation by the executive branch, by the housing GSEs themselves and their competitors, and by the public.

This review, of course, does not preclude immediate action with respect to the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO's mission could well benefit from budget independence and the granting of the same full powers in use by other banking supervisors, including the Finance Board under the Federal Home Loan Bank Act.

The Federal Home Loan Bank Act grants the Finance Board the authority, the independence, and the Executive Branch voice needed for robust supervision of government sponsored public trusts.

Through FIRREA in 1989 and Gramm-Leach-Bliley a decade later, Congress drew on the lessons of the thrift crisis and the poorly conceived Federal Home Loan Bank Board to shape the Finance Board into a safety and soundness and mission watchdog for the Federal Home Loan Banks, granting the Finance Board all the authority and independence needed to be a world-class regulator.

The Federal Home Loan Bank Act provides:

- Enforcement authority on a par with other federal bank regulators;
- Flexibility to tighten capital standards and risk monitoring, if needed;
- Authority to review and approve new business activities in advance;
- Authority to define and monitor affordable housing programs conducted by Federal Home Loan Banks;
- Full authority to liquidate a Bank, to establish a replacement, or to merge weakened Banks;
- The freedom to garner budget resources from the Banks and to deploy them as most needed; and
- A direct voice on the Board for the Executive Branch in overseeing the Home Loan Banks' role in capital markets and mortgage markets.

None of these tools is found in OFHEO's statute. These tools should be considered for inclusion if Congress decides, after determining the appropriate future roles of housing GSEs, that a new regulator for some or all of the enterprises is required.

OVERVIEW

To properly consider the effective oversight of housing GSEs, as now constituted, Congress should proceed on the basis of proposals from the Administration and several Members that seek to increase the tools available to supervise Freddie Mac and Fannie Mae.

As mentioned, the Federal Home Loan Bank Act, as amended by FIRREA and Gramm-Leach-Bliley, equips the Federal Housing Finance Board with the full set of supervisory tools required for world-class oversight. Increasingly, these powers are aggressively and ably employed by the Finance Board.

Because markets are sophisticated and place a premium on actual performance and verifiable information, I do not believe simply changing the name or status of the agency responsible for the Federal Home Loan Bank Act will result in more favorable treatment of FHLBanks by investors. I know of no study concerning federal thrifts and national banks, for example, substantiating the premise that distinct but effective regulators affect the price of borrowing by federal thrifts and national banks.

As this debate refocuses on substantive and difficult questions, it will be necessary to distinguish the risks inherent in the housing GSE's banking functions, the unique risks associated with housing GSE status, and the nature of possible future problems.

It is also important to recognize that remedying the known shortcomings in the '92 GSE act regulating Freddie Mac and Fannie Mae and/or transferring Federal Home Loan Bank Act authority to a new body will not, in and of themselves, reduce or dilute the potential risks posed by the housing GSEs to the taxpayers and the economy. The housing GSEs are banking enterprises, and banking is an inherently risky business. In the housing GSE sector, these risks and market share are highly concentrated in the two largest enterprises.

The housing GSEs have grown exponentially in size, sophistication, and inherent risk as capital and mortgage markets have revolutionized. All 14 housing GSEs now play critical roles in domestic and global capital markets and in U.S. housing markets. That growth, together with the reality of a perceived taxpayer guarantee, make it imperative that the Freddie Mac and Fannie Mae oversight statute be brought up to world-class and that Finance Board administration of the FHLBank Act complete its rapid evolution to world-class.

UNIQUE HOUSING GSE RISKS

For holding companies, commercial banks, thrifts, and credit unions supervised by federal banking agencies, the institutions' boards of directors determine the markets to be served, the products to be offered, and the pace of growth or retraction.

For housing GSEs, the broad parameters of markets served, products offered, and growth are driven by congressional charters.

These charters were framed in the 1930s and charged the FHLBanks, Fannie Mae, and later Freddie Mac with providing liquidity for lenders making long-term amortizing home mortgages. The housing GSEs were part of a set of New Deal policy innovations, including Federal Housing Administration mortgage insurance and the activities now conducted under the aegis of Ginnie Mae, which have succeeded beyond all reasonable expectations in establishing the long-term amortizing mortgage as the industry standard, creating a secondary market in these loans, and creating a securitization market based on these products.

The monopolies granted by both the FHLBank charter and the Freddie Mac and Fannie Mae charters also bear the seeds of systemic risk. Protection from broadly effective competition from other GSEs or fully private firms assists the housing GSEs in accomplishing their missions. But this benefit may also partially shield them from the harsher realities of the marketplace that tend to reward the best capitalized, best managed corporations in a given sector.

Closely associated with monopoly privileges is the taxpayer guarantee that appears to flow from the bare fact of government sponsorship and from the tax exemptions, securities law exemptions, Treasury “line of credit,” and other benefits of that sponsorship. Anecdotal but consistent and long-standing evidence indicates that the “implied guarantee” and “agency debt” status are extremely valuable attributes. This distraction from assessing the credit-worthiness of housing GSEs on wholly tangible grounds is another systemic source of risk unique to these 14 enterprises.

Moreover, because the GSEs are expected to serve all markets through all parts of the business cycle, and more importantly, because the fundamental missions and roles have not been re-calibrated as fully private firms have successfully followed the GSEs into most mortgage finance products and services, housing GSEs tend to grow without meaningful restrictions.

As housing GSEs acquire greater exposure to inherent banking risks through growth, they also are exposed to increased risk as a result of their participation in derivatives, securities, and debt markets which have become more global, more sophisticated, more innovative, and more rapidly-evolving.

These factors, weighed with the systemic risks of GSE status, argue that housing GSE risk in the future can only be significantly reduced by curtailing inefficient protections from competition and/or by re-calibrating the charters so that housing GSEs actually shrink as fully private firms successfully take over some of the mortgage finance products and services now dominated by GSEs.

The safety and soundness regulators of the housing GSEs are not the appropriate bodies for designing or effecting these charter reforms. The government sponsored enterprises, by definition, are charged with accomplishing public objectives through private ownership. Only the public’s representatives, the Congress and the Administration, can validly assess the need for future GSE participation in housing finance and capital markets and assign the benefits and obligations consistent with that need. The Congress and Administration are also the only valid bodies for determining the amount of risk to taxpayers and the national economy appropriate to the contributions of housing GSEs.

Once the future roles of housing GSEs are assigned and the appropriate risk level is determined, it should be, as it is now, the duty of the Finance Board, OFHEO, and the Department of Housing and Urban Development (HUD), or whatever successor agencies

Congress and the Administration may create, to police their governance and operations in managing inherent risks and their fidelity to housing GSE charters.

THE FUTURE OF HOUSING GSE SUPERVISION

Mapping the future of housing GSE oversight, properly calibrated to match the future roles and risks of the enterprises, begins with an honest assessment of the authorities governing the operation of OFHEO and the Finance Board.

When Congress established a regulator for Freddie Mac and Fannie Mae in 1992, it did not provide OFHEO with all the tools and independence of the Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), or Federal Reserve.

Even taking into account the new product and affordable housing portfolios assigned to HUD, these two housing GSEs are not supervised on fully comparable terms to federal credit unions, national banks, federal thrifts, bank holding companies, or, for that matter, the Federal Home Loan Banks.

The '92 GSE act's deficiencies in funding and in supervision and enforcement tools and flexibility should be addressed.

The Administration's proposals and some congressional proposals largely bring to bear on Freddie Mac and Fannie Mae budget resources and supervisory tools fully comparable to those available to other federal supervisors of financial institutions. The Administration also makes a common sense and plainly necessary proposal to give the public a role in shaping and overseeing Freddie Mac and Fannie Mae, which is similar to the Executive Branch participation on the Finance Board.

As outlined above, the Finance Board already is endowed with the resources, strength, independence, and supervisory scope that mark world-class safety and soundness regulators.

But until recently, the Finance Board was not fully discharging the mandates of the FHLBank Act or making full use of its independence and resources. Fortunately, these shortcomings are being rapidly and thoroughly rectified.

Today the Finance Board has more than double the number of examiners on staff when I took the oath of office in December of 2001 and my Board colleagues and I began the process of rebuilding the examination and supervision functions at the Finance Board. This corps of 18 examiners will expand to 30 by this time next year and has been supplemented by additional financial analysts, accountants, and risk management specialists.

The Finance Board is recruiting and hiring the best and brightest from other federal banking agencies. The average Finance Board examiner has over 17 years of examination experience, and every examiner is a commissioned examiner, has a professional accreditation, or both.

Finance Board oversight has improved in every way and the opportunity to work with the members of the Federal Home Loan Bank oversight team is now becoming a prestige career move.

Attached to this prepared testimony is an appendix providing more detail on the new FHLBank supervision program being put in place and the progress made to date. The numbers provided in the appendix are impressive, but more important is the explanation of how the Finance Board has entirely revamped its approach to FHLBank supervision over the past 18 months.

Certainly, the Federal Home Loan Bank Act already provides the Finance Board with power to meet any eventuality, and we are fast approaching world-class status in the size and skills, the capacity and sophistication, of our staff and their oversight of the 12 Banks.

Mr. Chairman, you asked me to address other specific issues in my prepared testimony. Allow me to do so at this point.

- **FUNDING PROCESS** – Independent boards have advantages and disadvantages compared to both the OCC/OTS model and to a less autonomous bureau within Treasury. One strength of an independent board is that budgets set by action of the Finance Board, for example, in public meetings provide a suitable degree of accountability in resource allocation without compromising independence through congressional or OMB review.

- **CAPITAL REGIME** – The minimum leverage requirements and risk-based capital requirements now in force for FHLBanks appear to be appropriate. Importantly, the Federal Home Loan Bank Act permits the Finance Board to increase or tailor these standards if experience demonstrates a need.

- **SEC REGISTRATION** – Only through conservative management and superior transparency and governance will all 14 housing GSEs maintain the highest measure of market confidence. I believe superior transparency requires that each FHLBank commit to voluntarily meet the quarterly and annual financial reporting requirements of section 12(g) of the Securities Exchange Act of 1934, as administered and enforced by the Securities and Exchange Commission (SEC). SEC registration and disclosure will enable markets to place greater reliance on and maintain greater confidence in the balance sheets, business prospects, and corporate governance of the FHLBanks. That is why, at its September 10, 2003, meeting, the Finance Board unanimously adopted and subsequently published for comment a proposed regulation requiring FHLBank '34 Act registration.

- OFFICE OF FINANCE – Before closing this discussion of the possible or feared effects of housing GSE regulator reform on the funding of FHLBanks, I must alert the committee to a question requiring considerable study before attempting any transfer of responsibility for administration of the FHLBank Act. The Act ratified the Federal Home Loan Bank Board’s establishment of the Office of Finance (OF) to issue consolidated obligations (bonds and notes) on behalf of the FHLBanks. Several years ago, the Finance Board devolved authority over management of the OF to a board of directors appointed by the Finance Board. The OF has also been assigned the task of compiling and issuing combined financial reports for the 12 FHLBanks.

But OF is an unusual corporate posture. It is not incorporated and has no balance sheet and no executive control of any FHLBank. OF instead acts as an agent for the FHLBanks and is the “name and face” shown to capital markets – which are not offered obligations in the name of any specific FHLBank, but rather “System” obligations issued through OF and backed by the joint and several liability of all 12 FHLBanks.

Understanding Treasury’s apparent wish to avoid providing any re-enforcement of the perception of an implied taxpayer guarantee behind housing GSE debt, Treasury’s views should be included in determining whether and how to shift authority over OF to Treasury.

CONCLUSION

Legislating the best set of tools and best structure for housing GSE supervision is an area of economic and housing policy that must be addressed.

Before again locking into statute a system of supervision for some or all housing GSEs that is not world class, policymakers from Congress, Treasury, HUD, and all 14 housing GSEs should begin the more comprehensive charter reform debate outlined above.

That comprehensive reform debate should sort out – 70 years after creation of GSEs and long-term amortizing mortgages – the most constructive role for housing GSEs in the mortgage finance marketplace of the 21st century. The questions policymakers should consider asking include:

- What is the right level of competition between housing GSEs and other mortgage financiers?
- What is the right level of competition among the housing GSEs themselves?
- What is the right level of risk to the taxpayers in proportion to the benefits the housing GSEs confer on the nation’s housing finance system?

Once a coherent national policy clearly outlining government and private roles in the future is in place, all parties to the debate will be fully equipped to design a world-

class supervisor able to evolve along with housing GSEs appropriately sized and appropriately directed to best support but not interfere with the markets of tomorrow.

I know of no immediate or imminent safety and soundness or liquidity imperative forcing us to do the job any way but the right way, and I think everyone is aware the stakes are high if the result is muddled.

I suggest, therefore, that the housing GSE reform effort move in a logical, deliberate manner to define the roles Freddie Mac, Fannie Mae, and the Federal Home Loan Banks should play in a continually innovating mortgage finance market, to define the appropriate risks to assume in the institutions fulfilling those roles, and then to determine how best to regulate the roles and risks and innovations that result.

Again, thank you for the asking me to speak to you today and for the attention this committee gives to homeownership, housing affordability, and housing GSE issues.

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APPENDIX

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Initiatives at the Federal Housing Finance Board to improve oversight of the Federal Home Loan Banks

For most of their history, the Federal Home Loan Banks were overseen by the Federal Home Loan Bank Board. That agency had a mixed mandate to help operate the Banks, to regulate the Banks' owners – federally insured thrifts – and to promote the Federal Home Loan Banks and thrifts.

Congress sorted out this puzzle with the passage of the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in 1989. Nevertheless, in a 1998 report, the General Accounting Office (GAO) found that the Federal Housing Finance Board – nine years after its creation – remained inadequately focused on safety and soundness supervision and too closely involved in operating the Banks, and at times appeared to be a cheerleader for the Banks, rather than an arm's length regulator.

Upon becoming chairman in December 2001, Chairman Korsmo determined these problems still existed and had to be corrected for the Finance Board to effectively oversee the Federal Home Loan Banks and Office of Finance for safety and soundness and achievement of their housing finance mission. Just one example demonstrates this point: At the time of the Chairman's appointment, the Finance Board had only eight bank examiners on staff to review and supervise a dozen financial institutions with, at the time, more than \$700 billion in assets, more than \$30 billion in capital, and some \$650 billion in outstanding debt. Yet, at the same time, the agency also had eight people in its Office of Public Affairs. The relative allocation of resources simply did not meet the agency's statutory mandates.

In addition to being understaffed, the examination function insufficiently focused on the Banks' risk assessment processes and the Banks' internal control systems. Such shortcomings had been identified in the 1998 GAO report on the Finance Board's examination program.

These circumstances called for an immediate and vigorous response, beginning with the recruitment of new leadership for the agency's Office of Supervision. Following a national search, the Finance Board brought on a new director and a new deputy director of supervision, who between them have 40 years of regulatory experience with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC).

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

Examiners represent the foundation of the Federal Housing Finance Board’s oversight function. The Finance Board has increased the resources available to fortify that foundation, expanding the agency’s examination staff to 18 full-time bank examiners as of October. The goal is to have 30 in place by the end of this fiscal year.

The examination staff, including the Deputy Director of the Office of Supervision, averages more than 17 years of professional experience in banking, mortgage finance, and bank examinations. All examiners are commissioned examiners or have a professional accreditation, and many have both. (See chart.)

Position	Highest Level Education	Years of Experience	Accreditations
Deputy Director	BS, Finance/Econ.	28	Commissioned Bank Examiner (CBE), Graduate School of Banking
Examiner/Associate Director	BS, Finance	19	CBE, Graduate School of Banking
Examiner/Portfolio Manager	MS, Finance	13	CBE, Chartered Financial Analyst (CFA)
Examiner/Portfolio Manager (Acting)	BS, Economics	9	Certified Public Account (CPA); CFA
Examiner	MBA	17	Certified Financial Institutions Examiner
Examiner	BS, Mgmt./ BA	25	Chartered Bank Auditor; ABA National Graduate Compliance School
Examiner	BA, Accounting	23	CBE; Certified Regulatory Compliance Manager
Examiner	MBA, Finance	16	CBE; Certified Risk Professional
Examiner	MBA, Accounting	17	Certified Investment and Derivative Auditor (CIDA)
Examiner	MBA, Finance	26	Federal Thrift Regulator (FTR)
Examiner	BBA, Finance	11	CBE; Graduate School of Banking; CFA Level II
Examiner	MBA	18	FTR; Certified Information Systems Auditor (CISA)
Examiner	BA	13	CBE
Examiner	BS, Finance	17	CBE; CISA
Examiner	BA, Economics	19	FTR; CFA Level I
Examiner	BS, Finance	10	CBE; CFA; Certified Financial Risk Manger; CIDA
Examiner	BA, Economics	16	Certified Financial Institutions Examiner
Examiner	BBA, Finance	13	CBE; CFA Level II

Position	Highest Level Education	Years of Experience	Accreditations
Examiner ¹	BA, Accounting and Economics	18	CPA, CFA Level II, Registered Securities Representative Series 7, 63
Examiner ²	BA, Business	24	Commissioned National Bank Examiner (NBE), Graduate School of Banking.
Mortgage Analyst	BS, Business	6	CFA
Mortgage Analyst	MBA, Finance	25	Registered Securities Representative Series 7, 63

In addition to adding highly qualified and experienced examiners to the staff of the Federal Housing Finance Board, the agency has also made a fundamental – and necessary – change in approach in the examination function. The Finance Board is now conducting more thorough, risk-focused examinations, and communicating the results of those examinations more effectively to the Banks.

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

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

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

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

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

¹ Accepted position. Starts at Finance Board in October.

² Accepted position. Starts at Finance Board in November.