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Thank you, Chairman Dodd, Ranking Member Shelby, and distinguished members of the committee. I appreciate the opportunity to present a statement to you about the importance of reform of the government sponsored enterprises. The views that I will be expressing today are mine and do not necessarily represent the views of my colleagues on the board.

It has been more than two years since I appeared before this committee, and a great deal has happened during that time. So, before I offer comments on government-sponsored enterprise (GSE) reform, I would like to provide you, the members of this committee, with a brief update on the financial performance and condition of the Federal Home Loan Banks (FHLBanks) and highlight the actions the Federal Housing Finance Board (Finance Board) has taken to enhance the safety and soundness of the System. I am confident that these steps benefit the public who are served by the housing finance and community development activities of the FHLBanks, as well as the FHLBanks and their shareholder/member institutions.

Background

The Finance Board's primary duty is to ensure that the 12 FHLBanks and their joint office, the Office of Finance, operate in a financially safe and sound manner. In addition, the Finance Board ensures that the FHLBanks carry out their housing finance and community lending mission, remain adequately capitalized, and remain able to raise funds in the capital markets. The Federal Home Loan Bank Act requires the Finance Board to examine each FHLBank at least annually. As an independent non-appropriated agency, the Finance Board sets its own budget consistent with fulfilling its duties and responsibilities. The Finance Board assesses the FHLBanks for the costs of its operations.

The 12 FHLBanks and the Office of Finance serve the public by promoting the availability of housing finance through more than 8, 079 member institutions. The FHLBanks principally provide a readily available, low-cost source of secured funding for their members and, to a lesser extent, a secondary market facility for home mortgages originated or acquired by their members. The FHLBanks are cooperatives; members own the stock of each FHLBank, and the members receive dividends on their investment. Insured banks, thrifts, credit unions, and insurance companies that are engaged in housing finance can apply for membership. Members purchase capital stock from the FHLBank as a condition of membership and also to capitalize any loans, called advances, they obtain from the FHLBank. Only a member institution can acquire an FHLBank's capital stock, and each FHLBanks is separately capitalized by its members.

The FHLBanks play a unique role in housing finance. They make advances, which are collateralized loans, to their members and eligible housing associates (principally state housing finance agencies). The advances are secured by mortgages and other eligible collateral pledged by members, their affiliates, and housing associates. Advances generally support mortgage originations, provide term funding for portfolio lending, and may be used to provide funds to any member "community financial institution" (an FDIC-insured institution with assets of $625 million or less) for loans to small business, small farms, and small agribusiness. This flexibility allows these advances to support diverse housing markets, including those focused on low- and moderate-income households.

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

FHLBank advances also offer larger member institutions a stable, competitively-priced source of funding. The FHLBanks have provided much needed liquidity and stability to financial markets over the past six months. Between June 30, 2007 and January 16, 2008, FHLBank advances increased from $641 billion to $877 billion. Much of the increase went to larger member institutions that found their access to alternative funding diminished by the turmoil in housing and financial markets. While the FHLBanks provide an unparalleled source of non-deposit funds for medium- and small-size members, the recent crisis has shown the invaluable help the FHLBanks can provide in supplying liquidity to larger members. Had the FHLBanks not been ready to provide credit to some very large members, the current liquidity squeeze in housing and financial markets would likely have been worse.

In 1989, Congress expanded the FHLBanks' public policy mission by establishing the Affordable Housing Program (AHP) and the Community

Investment Program (CIP). The FHLBanks provide funding to support affordable housing and community and economic development activities of their members through the AHP and CIP. The Finance Board examines and evaluates the FHLBanks' programs using specialist examiners.

Finance Board Operations

The Finance Board's fiscal year 2008 budget is $38.7 million, which represents an increase of $2.9 million compared with the agency's FY2007 budget of $35.8 million. Approximately 90 percent of this increase will expand the resources allocated to the examination and supervision of the 12 FHLBanks. Of the overall budget, $30.8 million, or about 80 percent, is allocated to the agency's safety and soundness supervisory program, and $7.9 million is allocated to the agency's supervision of the FHLBanks' affordable housing and community investment programs. This year's budget allows the agency's Office of Supervision to conduct annual examinations, monitor the FHLBanks' progress in addressing supervisory findings, evaluate FHLBank applications and requests, and prepare supervisory guidance and regulations. In addition, much of the work of the Finance Board's other offices, such as the Office of General Counsel and the Office of Management, supports, either directly or indirectly, the activities of the Office of Supervision through legal analysis; regulatory interpretations; and information technology, administrative, and organizational support. The Finance Board is a careful steward of the funds we assess the FHLBanks. As the data show, our expenditures are for activities that support the Finance Board's primary statutory duty – ensuring the safety and soundness of the FHLBanks.

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

With regard to the second principle, we expect the directors and management of the FHLBanks to adhere to the highest standards of ethics, corporate governance, accounting, and risk management. As GSEs, the FHLBanks enjoy a special privilege in the capital markets. Consistent with that privilege, we also expect the FHLBanks, as government-sponsored enterprises, to maintain low risk profiles and to prudently manage the credit, market, and operational risks to which they are exposed. The FHLBank System's consolidated obligations, for which the FHLBanks are jointly and severally liable, further underscores the need for each individual FHLBank to operate prudently and with high standards.

Let me next share with you some observations. They are observations drawn from my tenure as chairman of the Finance Board and they underpin the regulatory and supervisory operations of the Finance Board. The environment in which the FHLBanks operate has changed significantly in the past five years. There has been further consolidation in the financial services industry, increased use of derivatives to hedge mortgage activity, and changes in accounting, including adoption of new standards for accounting for derivatives. Those changes brought about increased risks and challenges to the business of the FHLBanks and contributed to increased earnings volatility.

In some instances, the FHLBanks did not respond quickly enough to keep pace with the changing environment. Some of the FHLBanks did not embrace and implement governance and risk management tools appropriate for the size and sophistication of their evolving business. A combination of inadequate skills, poor judgment, and control deficiencies contributed to problems at those FHLBanks. The problems at the Chicago and Seattle FHLBanks were such that the Finance Board initiated formal enforcement actions against them in 2004; the rapid growth in their mortgage programs combined with risk management shortcomings contributed to an increased risk profile and declining and more volatile earnings.

At the same time, the Finance Board has addressed shortcomings in staffing and examination resources that had existed for some time. For example, in 2002, the agency's Office of Supervision had just 13 staff members, including nine bank examiners and a mortgage specialist. That staff carried out both safety and soundness and AHP examinations. Risk modeling was rudimentary, costly, and time intensive. Today, we have 100 people in our Office of Supervision, including 42 examiners and mortgage specialists, of which 34 are responsible for safety and soundness examinations and eight are responsible for AHP and CIP examinations. In addition to the examiners and mortgage specialists, other Office of Supervision personnel participate directly in examinations. Financial analysts review the FHLBanks' earnings and condition data and prepare an assessment for each examination of the FHLBank's financial condition and performance. Financial economists monitor and evaluate each of the FHLBank's risk modeling processes and meet with the FHLBanks' quantitative risk modeling staff during examinations. Accountants review the financial statements of the individual FHLBanks and, most critically, are responsible for reviewing the FHLBank System's Combined Financial Reports prepared by the FHLBanks' joint office, the Office of Finance. Our technology has been upgraded, our data collection is more comprehensive, and our supervisory data bases have been integrated. Our off-site risk monitoring and modeling capabilities have been enhanced so that we are now better able to model and monitor the FHLBanks' risks, particularly the interest-rate risk in mortgage portfolios.

The FHLBanks and the Finance Board have undergone significant changes and faced serious challenges in the last few years. We have each learned some important lessons and acted on those lessons. The FHLBanks learned lessons in governance, record keeping and financial disclosure, and internal controls. Risk modeling has improved at the FHLBanks as has the comprehensiveness of their risk management. The Finance Board learned the benefits and need for early and resolute action when problems emerge. The Finance Board has also enhanced its supervisory program through new or revised regulations, supervisory guidance, a new examination rating system, and updated examiner guidance and procedures.

Condition and Performance of the Banks

At December 31, 2007, the combined assets of the 12 FHLBanks were $1.278 trillion, up from $1.021 trillion at the end of 2006. The majority of this increase in assets reflects advances that were extended to member institutions, particularly larger member institutions, after the onset of the crisis in the subprime mortgage market. The FHLBanks have provided substantial liquidity to domestic capital markets.

Advances are the largest asset class constituting 68 percent of combined FHLBank assets. Advances of $875 billion are 36.6 percent higher now than at the end of 2006. The distribution of advances among members reflects, in part, the concentration of assets in the financial services industry. The top 10 holders of advances account for 37.6 percent of the System total of advances, up from 35.6 percent at the end of 2006. Further, reflecting the increased importance of large member borrowing, the top 10 borrowers account for 43 percent of the net increase in advances in 2007. I expect Finance Board examiners to closely monitor advance concentrations at the FHLBanks to ensure that the FHLBanks do not become too reliant on any single customer or a relatively few large customers.

Members must capitalize their advances borrowings by buying FHLBank capital stock when taking out an advance. Capital purchase requirements vary by FHLBank, but normally the requirements range from 4 to 6 percent of the advance. Members also must collateralize their advances. Most common forms of collateral are residential mortgages and securities (including Treasury securities, agency securities, and mortgage-backed securities). The amount of an advance is discounted relative to the collateral. The "haircut" is generally less for securities than for mortgages and less for mortgages than for less liquid types of collateral. Haircuts typically range from as little as 3 percent of market value (e.g., Treasury securities) to approximately 20 percent or more of market value (e.g., unpaid principal balance of a mortgage) to 50 percent or more for less liquid types of collateral (e.g., second mortgages or home equity lines of credit). Each FHLBank has the right to demand additional collateral from a borrower or to refuse to make an advance to a member that fails to satisfy the FHLBank's underwriting criteria. We review FHLBank collateral policies, practices, controls, and audit reports during our annual examinations. FHLBanks must also have "responsible lending" policies concerning subprime and non-traditional loans as collateral and to avoid acceptance of "predatory loans" as collateral.

Mortgage loans purchased from members have declined over the past three years and continue to fall. After reaching a peak of almost $116 billion in June 2004, mortgage loans have been trending downward. This downtrend reflects general mortgage market conditions that are unfavorable toward the acquisition and holding of fixed-rate conforming mortgages as well as strategic decisions by several FHLBanks to de-emphasize the holding of mortgage loans. Mortgages held by the FHLBanks are $91.6 billion or 7.2 percent of assets, down from $98 billion or 9.6 percent of assets at the end of 2006.

The FHLBanks hold investment portfolios totaling $302 billion or 23.7 percent of assets. At December 31, 2008, these investment portfolios were primarily mortgage-backed securities ($143 billion), prime short-term money-market instruments ($143 billion), and federal agency securities ($13 billion).

In terms of MBS, the FHLBanks own approximately $88 billion of private-label MBS; the remainder is agency MBS. At the time of purchase, all these securities were rated triple-A. The Finance Board is closely monitoring developments in the residential MBS market. As of the end of January, the FHLBanks own one security that has been downgraded from triple-A to double-A. That security is under "negative watch" and 58 triple-A-rated securities are under "negative watch."

The FHLBanks principally fund their operations by issuing consolidated debt obligations for which each FHLBank is jointly and severally liable. The consolidated debt obligations are issued by the Office of Finance. Outstanding consolidated obligations are $1.190 trillion.

The total capital of the FHLBanks is $53.6 billion or 4.19 percent of assets. Total capital comprises all stock issued by the FHLBanks plus retained earnings. Of that total, retained earnings are $3.7 billion or 0.26 percent of assets.

In 2007 the FHLBanks' net income was $2.8 billion compared with $2.6 billion in 2006. The return on assets was 0.26 percent, which is the same as 2005 and 2006. As cooperatives, the FHLBanks can return the benefits of membership to members either through dividends or the pricing of advances. The return on equity that has been less than 6 percent annually for the past five years indicates that a significant portion of the benefits of membership come through favorable pricing.

Regulatory Action

The Chicago Bank continues to operate pursuant to a consent order to cease and desist. The Bank took actions and engaged in business activities that were imprudent. It had a high level of excess stock and was intent on growing its mortgage portfolio. The mortgage portfolio increased to 60 percent of assets and was supported by a commensurate amount of member excess stock. Thus, it was supporting long-term assets with stock that had a six-month call by the members. Safety and soundness issues related to its high level of excess stock intensified, and the Finance Board had to act. On October 10, 2007, the Bank accepted the terms of a consent order to cease and desist.

The order imposes restrictions on the Bank's repurchases and redemptions of its capital stock and its payment of dividends until supervisory concerns have been satisfactorily addressed. The action was necessary to improve the condition and practices of the Bank, stabilize its capital, and provide the Bank an opportunity to address the principal supervisory concerns identified. As reported in the press, the FHLBanks of Dallas and Chicago are discussing a potential merger. Any such merger would need Finance Board approval.

Reform of the GSEs

The Congress and the administration have discussed and debated reform of the GSEs for years. I believe it is now time to act. Together the FHLBanks, Fannie Mae, and Freddie Mac play a vital role in helping to finance homeownership for millions of Americans and stabilizing and strengthening housing and financial markets and the economy at large. Given the size and significance of these institutions, which together have more than $3 trillion in assets, it is imperative that they be supervised and regulated by a single federal regulator and that the regulator have all of the tools necessary to provide effective and thorough oversight.

The federal banking agencies have a full arsenal of supervisory and enforcement tools at their disposal, which allows them to take early and resolute action, if necessary. Those tools include examination, capital, and enforcement authority over the institutions they regulate. A new GSE regulator should, at a minimum, have the same tools possessed by the federal banking agencies.

In particular, a new GSE regulator should have the ability to fund itself through assessment of the GSEs and be outside of the appropriations process; it should have the ability to place a GSE into receivership or conservatorship, it should have the authority to approve new and existing business activities; and it should have the power to set minimum capital levels. The Finance Board already has the authority to assess the FHLBanks to fund its operations. Among the federal financial institution supervisory agencies, only OFHEO relies on appropriated funds. In addition, the Finance Board has the authority, and exercises it, to require an individual FHLBank to have and maintain additional capital, to approve new business activities, and to regulate the composition of the FHLBanks' asset portfolios.

A single unified GSE regulator would provide for a more efficient and effective regulatory body. It would be more efficient in its ability to share examination and supervisory information among examiners and other agency staff. The agency's risk modeling would be enhanced by greater interaction and consultation among the quantitative risk professionals already in place at OFHEO and the Finance Board. Examination and risk management expertise and resources could be shared, as appropriate, particularly in dealing with complex or significant supervisory matters at one of the enterprises or the FHLBanks. Finally, all GSEs should have to meet the same high governance and disclosure standards. At present, all 12 FHLBanks are registered with the Securities and Exchange Commission (SEC) and are subject to its oversight of their financial statements and disclosures.

While I believe consultation and interaction are critical attributes of a single federal regulator for the housing-related GSEs, the differences between the FHLBanks and the enterprises must also be recognized and accommodated through any legislation that would reform GSE supervision. The FHLBanks are member-owned cooperatives. Their corporate structure and their business operations are far different from that of shareholder-owned Fannie Mae and Freddie Mac. These differences exhibit themselves in different capital structures, different board structures, and different orientations towards returns to stockholders and pricing of products to their customers. Also, the essence of the FHLBanks' business is secured lending where most of the collateral is mortgage loans; the FHLBanks do not securitize mortgages and direct mortgage holdings are only 7.2 percent of total assets.

Conclusion

The recent stress in the housing market has taught us that GSEs are vital to supporting the nation's housing needs. In particular, FHLBank advances have provided critical liquidity to members whose alternative sources of funding had dried up. A single regulator would assure homebuyers and market participants that the overseer of the housing GSEs speaks with a single voice, acts with a consistent purpose and is clear, consistent and vigilant. While the housing GSEs can and do operate in a variety of different ways to fulfill their housing finance mission, they have a common heritage, they share many of the same customers, they raise funds from the same sources and the recent environment has shown us that whether they securitize mortgages, own mortgages or take them as collateral, they have common concerns. Simply put, reform of the GSEs makes sense. It will help to promote a healthy and vibrant housing market.