Statement of

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Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I am Richard Swanson, President and CEO of the Federal Home Loan Bank of Des Moines. Thank you for the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks (Council), an association representing all of the Federal Home Loan Banks (FHLBanks).

The 12 regional FHLBanks are member owned cooperatives with over 7,500 member financial institutions – of all sizes and types - nationwide. The Federal Home Loan Bank of Des Moines ("FHLB Des Moines" or "Bank") is a valuable and reliable partner to nearly 1,200 community lenders throughout Iowa, Minnesota, Missouri, North Dakota and South Dakota. (Please see Attachment 1 for an in-depth overview of the FHLBanks.)

At the outset, you are to be commended for the thoughtful and deliberate approach being taken by the Committee to reform and restructure the mortgage finance system. This is a complex task that will have far reaching impact on a sector of the economy that dwarfs most others. Some estimates place housing's share of the economy at over 15 percent.[1]

The Committee's focus today on protecting small lender access to the secondary mortgage market is well placed. For the past 25 years, I have devoted my career primarily to the success of small financial institutions in meeting the housing finance needs of the communities they serve, first as the president of a community bank and now as the chief executive officer of a cooperative wholesale bank that provides low cost funding and liquidity, as well as secondary market mortgage support and other services, to its 1,200 members – almost all of whom would be considered "small lenders" by any definition.

When the FHLBanks were created by Congress in 1932, virtually all home loans were made by small lenders. Our central purpose then, as now, was to provide lenders access to a reliable and stable source of liquidity and funding so that they could meet the credit needs of their communities at all points in an economic cycle. For small lenders who originate home loans in excess of what can be held in their own portfolios (i.e., as assets on their own balance sheets), many of the FHLBanks have also provided access to the secondary market over the past 16 years. The FHLBanks' experience with their mortgage programs is certainly relevant to decisions that need to be made regarding the future of the housing finance system, and we are uniquely positioned to play an important role in the housing finance market of the future.

Recognizing that the focus of this hearing is on small lenders, it is important to keep in mind that the presence and active participation of members of all sizes and varied types, including thrifts, commercial banks, credit unions, insurance companies, and community development financial institutions, has been a key factor in the success of the FHLBank cooperative model. The FHLBanks can help ensure that financial institutions of all sizes have equal access to secondary mortgage funding nationwide so that their customers can obtain competitive market rate mortgage loans in all business cycles and their communities remain vibrant.

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[1] National Association of Home Builders, October 2013.

Why Are Small Lenders Important to the Housing Finance System?

With deep customer relationships, community lenders are natural mortgage lenders. Readily available access to additional sources of funding and the secondary mortgage markets strengthens the ability of community lenders to provide housing finance; likewise, the secondary markets are strengthened by the quality of mortgages originated by community lenders.

Community lenders remain significant players in housing finance, notwithstanding the continuing pace of greater concentration being observed in mortgage originations. The core strength community lenders bring to the market is their deep knowledge of local markets and their personal relationship with customers. In smaller communities and in rural markets, community lenders are often the sole source of mortgage credit as larger institutions typically focus on more densely populated areas.

While not having the dominant share of originations, smaller lenders originate a significant amount of mortgage loans. In 2012 there were 7,047 lenders with less than $1 billion in total mortgage originations, compared to 272 lenders above that amount. The lenders with total originations less than $1 billion accounted for approximately $528 billion, or 26 percent of the market last year. [2]

What Do Small Lenders Need to Serve Their Customers and Communities?

From the FHLBank Des Moines experience in assisting smaller lenders in the mortgage markets, community lenders need the following to serve their customers and communities:

- The ability to provide a range of mortgage loan products to meet customer needs in all market conditions:
    - Although some loans, such as adjustable rate and balloon mortgages, can be held by small lenders in their own portfolios, these lenders may need a source of funding for those loans other than customer deposits.
    - Other mortgage loans, including long term fixed rate loans, are not usually retained by smaller lenders due to the difficulty of managing the interest rate risk these prepayable loans present.
- Access to the secondary market on terms fair to small lenders.
- Pricing of their mortgages based on the credit quality of the loans they make, as opposed to the quantity of loans they sell.
- The ability to sell mortgages to the secondary market on a single-loan basis that is impartial, efficient, and provides equitable pricing for community lenders. Most

[2] All data is from HMDA.

community lenders do not originate sufficient volume to pool and/or securitize their mortgages.

- The ability to service their mortgage loans or to sell servicing of their mortgages on reasonable terms to a party who will provide excellent service to, without competing for, their customers.

How Do the FHLBanks Help Small Lenders Provide Home Loans?

The FHLBanks help small lenders provide mortgages in many ways:

- The FHLBanks provide cost-effective, flexible funding for loans that small lenders hold in portfolio, including funding for adjustable rate and balloon mortgages, as well as long term fixed rate loans. Managing the interest rate risk involved in longer term fixed rate loans is challenging, and the FHLBanks offer a variety of advance products to meet the needs of these lenders. Members can obtain long term fixed rate funding to match the mortgages held in portfolio. Amortizing advances are available that can be matched to a portfolio of mortgages the member holds. Advances are also available that allow members the option to prepay the advance without a fee to manage the interest rate and prepayment risks of the member's mortgage portfolio.

- The FHLBanks offer mortgage programs that enable smaller lenders to sell long term fixed rate loans on reasonable terms. With the development of the securitization market since the creation of the FHLBanks, the majority of mortgage loans in the United States are now pooled into securities that are held by investors throughout the world. While providing funding and liquidity to members through advances remains the core business of the FHLBanks, supporting the success of members by offering them access to the secondary mortgage market is another way that the FHLBanks have fulfilled their mission.

- When a community lender originates and later sells loans to secondary market investors, the FHLBanks may provide warehouse lending, funding the loan between the time the loan is closed and the loan is sold.

- The FHLBanks also provide technical assistance to members in understanding how to quantify and manage the interest rate risk from holding mortgage loans, as well as in documenting and underwriting loans so that they qualify for sale to the secondary market.

What Challenges Did Small Lenders Have Before the FHLBank Mortgage Programs?

Prior to the FHLBank mortgage programs, community lenders had three choices when originating conventional, fixed rate mortgage loans, each of which presented significant challenges for small lenders:

- One option was for community lenders to hold the loans to maturity on their own balance sheets. Although holding loans to maturity on their balance sheets enabled community lenders to retain customer relationships through loan servicing, this option presented community lenders with difficulties in properly funding and hedging the interest and prepayment risks of long term fixed rate mortgage loans at a cost competitive with secondary market alternatives.

- Alternatively, the community lender could sell conventional, fixed rate loans to the secondary market. However, when selling loans directly to Fannie Mae and Freddie Mac, smaller lenders were disadvantaged by having to pay higher "guarantee fees" than larger lenders. The guarantee fee structure rewarded high volume lenders, and further disadvantaged smaller lenders by not compensating them for the superior credit quality and performance of their loans.

- Community lenders could also sell loans directly to a larger financial institution which would aggregate mortgages from many smaller lenders and sell them to the secondary market. Under this option, while the larger institution might receive the benefit of a volume discount from Fannie Mae or Freddie Mac, this discount would not necessarily be passed on to the small lender. This option often resulted in unfavorable pricing to the small lender as a result of increased transaction costs. This option also had the further disadvantage of providing a potential competitor the opportunity to solicit customers from the smaller lender.

The FHLBank Mortgage Programs

For the last 16 years, the FHLBanks have been providing members with secondary mortgage market options through our MPF and MPP mortgage programs. The FHLBanks have filled a need in the secondary mortgage market by providing a competitive outlet for the sale of high quality mortgage loans originated by community lenders. These programs give participating members access to the secondary market through several channels:

- Mortgage Partnership Finance® (MPF®) Program – The MPF program involves the purchase of qualifying conventional loans and government insured loans by participating FHLBanks. This program offers a variety of risk sharing arrangements ("skin-in-the-game") while allowing Participating Financial Institutions to continue to manage all aspects of the customer relationship. The program was created by the FHLBanks to fill a need in the secondary mortgage market for community lenders who were unable to sell mortgages at prices that reflected their superior credit quality. The MPF Program operates on the premise that by combining the credit expertise of a local lender with the

funding and hedging advantages of a FHLBank, a stronger, more economical and efficient method of financing residential mortgages results.

- Mortgage Purchase Program (MPP) – Similar to the MPF program, the MPP program provides members the ability to sell conforming loans at a competitive rate with the potential to recognize additional revenue if the loan performs well. Under the MPP program the FHLBank is protected against credit loss through a feature called the lender risk account (LRA), which again serves as the member/seller's "skin-in-the-game". Under the LRA, funds are set aside to cover potential loan losses. If the funds are not needed, they are returned to the seller over time. The seller has the potential for a higher all-in return if it originates and sells mortgages of high credit quality.

- MPF Xtra® Program – The MPF Xtra program allows members to sell their loans through participating FHLBanks to Fannie Mae at a more favorable price than they could obtain individually, but without any risk sharing obligation. This pass-through service, by which members benefit from a form of volume discount, complements the other FHLBank mortgage programs.

By using the FHLBank mortgage programs, community lenders have the ability to:

- Gain more favorable access to the secondary market, since the FHLBank mortgage programs are designed primarily for smaller lenders.
- Control the origination and underwriting process.
- Engage in a business relationship with a secondary market partner that is a cooperative in which they have an ownership interest as well as a voice, rather than with a potential competitor for their customers.
- Offer competitive mortgage pricing to their customers in spite of their smaller size and volume.
- Retain a small portion of credit risk in their loans ("skin-in-the-game") while transferring the interest rate, prepayment and liquidity risks to the FHLBanks.
- Increase their income by receiving future credit enhancement fees based on the credit performance of the mortgages they originate.
- Determine whether to service their mortgages or transfer the servicing to a non-competitor that has been pre-qualified as a servicer by their FHLBank.
- Preserve their customer relationships.

The FHLBanks' MPF and MPP mortgage programs have proven to very popular with FHLBank member institutions and have provided great value to them. The credit history of the programs has been exceptional. Following is a summary of their performance over the past 16 years:

- Over 1,500 member institutions, located in all 50 states, have used one of these programs to provide mortgages for their customers. Of these members:

    - 70 percent have assets of $500 million or less;

    - 30 percent have assets of more than $500 million.

- The median size of these mortgages is about $135,000.

- The credit quality of mortgage loans funded by FHLBank members has proven to be excellent. The programs have experienced extremely low losses, particularly conventional loans funded through a program that uses a risk sharing structure that ensures member lenders keep "skin-in-the-game".

- Of the $202.5 billion in conventional mortgages funded through either the MPF traditional program or the MPP program since their inception, only $303.6 million of losses have been realized, as of June 30, 2013. This represents a loss ratio of only one fifteenth of one percent -- 0.15 percent or 15 basis points.

- Only 1.78 percent of these loans were 90 days or more delinquent, or slightly more than half of the national average of 3.24 percent.[3]

The very low level of credit losses (15 basis points) sustained by FHLBanks and their participating members since the beginning of these programs is truly remarkable considering it includes the period of time when the most severe economic stresses in the housing and credit markets in over 80 years were experienced.

The FHLBank risk sharing mortgage programs are built on the foundation of sound underwriting by our members who originate high quality mortgages from customers they know. Consistent with secondary market conforming loan requirements, the mortgages purchased through these programs are required to have loan-to-value ratios (LTVs) not greater than 80 percent of appraised value at origination, either through down payments or mortgage insurance. In addition, these loans were made by community lenders who have the best interests of their retail customers in mind. As a result, most community lenders have such confidence in the credit quality of the loans they make that they are willing to share the credit risk associated with their own mortgage originations.

I would like to briefly describe my Bank's experience with credit risk sharing. The way the credit risk sharing works under the MPF Traditional 125 program, for example, is that the first layer of losses for each Master Commitment is paid by FHLB Des Moines up to the amount of the First Loss Account (FLA) which is 1 percent of the delivered amount of loans in the Master Commitment. The member institution that originated the mortgages then provides a second loss credit enhancement obligation (CE Obligation) for each Master Commitment. On average this is about 4 percent of the delivered amount of loans. To the extent that losses do not exceed the FLA, the member institution is compensated for retaining a portion of the credit risk and receives a monthly credit enhancement fee from FHLB Des Moines. Loan losses beyond the first and second layers are absorbed by FHLB Des Moines.

The following is a typical example of how the credit risk sharing functions for a member of FHLB Des Moines: A community lender in eastern Iowa has been a FHLB Des Moines Participating Financial Institution since 2004. Over the past nine years this institution has sold

[3] As reported by the Mortgage Bankers Association's National Delinquency Survey for June 30, 2013.

the Bank 3,481 mortgage loans for a total of $393 million. The average loan size is $112,000. The member institution services these loans and to date has received $2.1 million in cumulative servicing fees plus an additional $965,000 in credit enhancement fees (reward for having skin-in-the-game). These fees continue to accumulate over the life of the loans. If the institution had sold those same loans to any other investor it would not have received the credit enhancement fee of almost $1 million of non-interest income. Only $13,000 in losses have been realized to date on the nearly $400 million in mortgage loans for which this member retains "skin-in-the-game." These losses were covered by FHLB Des Moines through the First Loss Account (FLA), but reduce future credit enhancement fees to the member.

What Do Small Lenders Need to Succeed in a Reformed Secondary Mortgage Market?

Under any mortgage finance reform proposal, including S. 1217, two fundamental challenges must be met if small lenders are to be able to compete successfully and serve the needs of their customers and communities.

- First is the challenge of small loan **volume**. How can a few loans made each month by many community lenders be sold to the secondary market on terms that are competitive with large volume lenders?

- Second is the challenge of obtaining fair pricing for the **value** of mortgages that come from community lenders. How can small lenders receive better pricing for their mortgages if they demonstrate better performance, and therefore have higher value to secondary market investors?

The FHLBanks can play a key role in helping meet both these challenges.

How Can the FHLBanks Support Small Lenders in a Reformed Secondary Market?

Depending on how the legislation is finally structured and accepted by the marketplace, the FHLBanks could play an even larger role in helping smaller lenders successfully access the secondary market.

<u>Addressing the Challenge of Volume</u>

Building upon the deep relationships we already have with our members, the FHLBanks have demonstrated the capability of aggregating small origination volumes from many lenders to produce an overall combined volume that can be competitively priced in the secondary market. The FHLBanks have the potential to further support their members as an intermediary to the secondary market of the future in the roles of aggregating, pooling, and sale or securitization of member mortgages.

So far our mortgage programs either purchase loans from members to be held to maturity on the balance sheets of the FHLBanks, or they enable a pass through sale by members directly to the secondary market. In a reformed secondary market, Fannie Mae and Freddie Mac will no longer

dominate the aggregating, pooling and securitization functions. It appears these functions will be distributed among more parties, potentially including the FHLBanks.

By aggregating loans from our many members, and holding them on our balance sheets -- not for long term investment but for a sufficient time to enable pooling of sufficient volume for efficient and well priced issuance of mortgage-backed securities in the secondary market, the FHLBanks will be able to further improve the pricing of secondary market loans for our smaller members.

By purchasing mortgages from community lenders the FHLBanks would hold mortgages on their balance sheets for a period of time until mortgages acquired from multiple members could be efficiently pooled for sale or securitization into the secondary market. By serving this aggregation and pooling role, FHLBanks could utilize their unique qualities and competitive strengths to support their members in originating mortgages. At the same time, by selling pools of mortgages from their balance sheets into the secondary market at more favorable pricing than their members could obtain individually, the FHLBanks would roll over their portfolios and would not be as constrained by volume limitations or challenges in managing long term interest rate risk.

The secondary mortgage market envisioned by S. 1217 would allow for the FHLBanks to serve in such an expanded role as mortgage aggregators. This could enable the FHLBanks to provide significant additional benefits to their members in addressing the challenges of obtaining competitive secondary market pricing for smaller volume community lenders.

Addressing the Challenge of Value

In the reformed secondary market contemplated by S. 1217, any pool of mortgages securitized with the backstop government guarantee would have to obtain private capital insurance covering the first 10 percent of losses. Assuming that this private capital loss coverage is provided by multiple parties meeting the capital and other requirements of FMIC, we would expect to monetize superior value of loans we purchase from community lenders by obtaining competitive bids for that loss coverage. Pools of higher value mortgages should command a lower premium.

The cost of loss coverage might be further reduced if our members elect to retain part of the risk on mortgages they sell to their FHLBank as they do under our portfolio mortgage programs. Such a "skin-in-the-game" program might be very popular among smaller lenders if it results in an even better price for their mortgages or a credit enhancement fee if their mortgages perform well.

If the reformed secondary market does not provide for competition by qualified providers of private capital first loss coverage of securitized mortgages, it is likely to result in a secondary market that rewards loan volume and not loan quality. Assuming FMIC charges uniform premiums for all securities backed by the government guarantee, the structure and regulation of the private first loss guarantors will be very important in order to assure competition that, in turn, will enable the FHLBanks to assist smaller lenders in receiving fair pricing for their mortgage loans.

Housing finance reform legislation should also ensure that FHLBank members who are willing to retain some level of risk for the performance of their mortgages can be rewarded for superior quality through lower private guarantor fees up front and/or credit enhancements fees paid over the life of the mortgages if they perform well. Building upon their existing "skin-in-the-game" mortgage programs, FHLBanks can perform a valuable function by facilitating the retention of some risk by smaller members on their mortgages to reduce the cost of private capital loss coverage, thereby allowing smaller lenders to be appropriately rewarded for the value of their loans.

S. 1217 – the "Housing Finance Reform and Taxpayer Protection Act of 2013"

We are pleased that S.1217 recognizes the importance of maintaining a role for institutions of all sizes in the housing finance system of the future, and contains provisions intended to preserve equal and reliable secondary market access for small and mid-size community financial institutions to help maintain reliable access to mortgage credit throughout all parts of the country. We appreciate that the bill provides different options for the FHLBanks to serve their members as the housing finance system of the future evolves. With the support and guidance of our members, we are open to exploring opportunities to expand our support of community lenders. At the same time, we emphasize the paramount importance of maintaining and protecting our continuing role as a reliable source for our members of liquidity and funding through advances.

S. 1217 has several features that could enable smaller lenders to be successful in providing mortgages in the future. The bill presents a hybrid solution that includes substantial private capital and a catastrophic government backstop. This hybrid solution includes private capital for losses related to mortgage defaults; but, in times of financial crisis, when private capital is insufficient to absorb those losses, the government would step in. Mortgage borrowers who benefit from the government backstop would pay a fee to compensate the government for potential losses. All non-Ginnie Mae, government-guaranteed securities would use a common securitization platform which would produce a more liquid market, facilitate loan modifications in future downturns, give issuers operating flexibility at a low cost, and permit multiple originators to sell mortgages into single securities with access to the government guarantee.

S. 1217 also contains provisions that would substantially alter the regulatory framework of the FHLBanks. As introduced, S. 1217 transfers the supervisory and regulatory functions relating to the FHLBanks from the FHFA to the FMIC on the "transfer date", which is one year after the date of enactment. One of the three offices within FMIC provided in the bill is an Office of Federal Home Loan Bank Supervision, headed by a Deputy Director appointed by the FMIC board, to regulate and supervise the FHLBanks.

Regulatory oversight of the safety and soundness of the FHLBanks' traditional liquidity and advance business on behalf of their members has little to do with the anticipated secondary mortgage market supervision and insurance functions of the FMIC. Accordingly the Council recommends that the FHFA's existing supervisory and regulatory authority with respect to the FHLBanks not be transferred to the FMIC. Instead, if the FHFA is abolished, the FHLBanks

should be supervised by a stand-alone independent regulator governed by a board structure, the members of which reflect a balance of experience and knowledge, including housing finance and community lending.

Under S. 1217, the FMIC is given extensive duties and responsibilities, including ensuring to the maximum extent possible a liquid and resilient housing finance market and the availability of mortgage credit while minimizing any potential long term negative cost to the taxpayer. These broad responsibilities of the FMIC over the entire housing finance market, along with the wide ranging authorities accompanying them, could potentially create conflicts with, and could certainly overshadow and impede, effective regulatory focus on the FHLBanks. The FHLBanks and their members have experienced the adverse effects of regulatory conflicts in the past, in pre-FIRREA times, and believe that it would be unwise to repeat that experience.

Conclusion

Mr. Chairman, thank you again for the opportunity to appear before you today. I would be happy to answer any questions. On behalf of the Council, I look forward to working with the Committee as you continue your work on this important matter.

Attachment 1

Federal Home Loan Bank Overview

The FHLBanks were created in 1932 to support America's housing finance system through their member thrift institutions and insurance companies. Since that time, Congress has expanded the mission of the FHLBanks to include support for affordable housing, community development, and other forms of community lending and has expanded eligibility for membership in the FHLBanks from thrifts and insurance companies to commercial banks, credit unions, and community development financial institutions. Advances (fully secured loans to member institutions) represent the core of the FHLBanks' business. Members rely on the FHLBanks to provide competitive access to liquidity and funding across all economic and credit cycles. The readily available cost- effective liquidity and funding with specific terms and features enhances the financial strength of local lenders so that they can meet the housing finance and other credit needs of their communities through a range of products and services.

During the nation's financial crisis, when dislocations in the capital markets made funding from other sources difficult, the FHLBanks were a critical source of liquidity for U.S. financial institutions, preventing far greater losses and potential failures. To meet the sudden need for liquidity during the crisis, the FHLBanks provided increased funding to members of all sizes and in every part of the country by $370 billion - from total outstanding advances of $650 billion in the second quarter of 2007 to over $1 trillion in the third quarter of 2008. The FHLBanks were able to carry out this essential liquidity function for their members without government direction or requiring taxpayer assistance. It was a direct result of the way in which the FHLBanks are structured, operated and prepared in all conditions to fulfill their mission.

The FHLBanks' Unique Structure Have Enabled Them to Successfully Fulfill Their Mission Since 1932

The FHLBanks have been able to successfully fulfill their mission as a result of several unique characteristics: their cooperative structure; a scalable, self-capitalizing, operating model; broad participation by a diverse membership; and dependable access to a deep, liquid market for FHLBank debt.

Cooperative Structure

The FHLBanks have a unique structure, comprised of twelve independent cooperatives and the Office of Finance that issues debt on behalf of those twelve regional FHLBanks. The FHLBanks are overseen by an independent regulator, the Federal Housing Finance Agency (FHFA), established by the Housing and Economic Recovery Act of 2008 (HERA Act of 2008). Each FHLBank is a separate and distinct corporate entity with its own member/shareholder institutions and its own board of directors. While the FHLBanks issue debt collectively and are jointly and severally liable for the repayment of those debt obligations, there is no single controlling entity with responsibility for or authority over the FHLBanks. Each FHLBank operates independently under the authority granted by Congress through the Federal Home Loan Bank Act, as amended,

and in accordance with the regulations established by the FHFA. Each FHLBank is registered with the SEC and files periodic financial reports and other information at a level of transparency comparable to other large public companies.

Each FHLBank operates within a district originally established by the Federal Home Loan Bank Board, one of the predecessors to the FHFA. Each FHLBank's capital stock can only be purchased by its member institutions. Each member must purchase the FHLBank's capital stock in order to become a member, and must maintain capital stock holdings sufficient to support its business activity with the FHLBank in accordance with the individual FHLBank's capital plan.

Scalable, Self-Capitalizing, Operating Model

The FHLBanks are built to be scalable - advance levels ebb and flow with credit cycles to match member demand. Since the height of the economic crisis, advances have declined by more than half as reduced loan demand and excess liquidity have reduced members' need for advances. The decline in advance levels, following their rapid expansion, demonstrates that the FHLBank model works as intended. Throughout this period, moreover, the FHLBanks have remained profitable and increased their combined capital ratios.

As cooperatives, FHLBanks are not subject to the growth imperative that often drives the decisions of publicly-traded corporations. Demand for advances expands and contracts with economic and market conditions and the FHLBanks' capital stock outstanding appropriately adjusts to these changes. Although the specific requirements vary based on each FHLBank's capital plan, an institution must hold a certain level of capital stock to be a member. In addition, a member must maintain "activity-based" capital stock in proportion to the amount of advances it has outstanding.

During periods of credit expansion, the activity-based stock requirement automatically provides additional capital to support advances growth. For example, in the recent liquidity crisis, the significant increase in advances was accompanied by the purchase of additional capital stock to support those advances, thereby providing additional capital to the FHLBanks in direct proportion to the increase in assets. This allowed each FHLBank to meet the liquidity needs of its members while preserving the safety and soundness of the cooperative.

An FHLBank's capital stock cannot be issued to or held individually by members of an FHLBank's board of directors, its management, its employees, or the public, and is not publicly traded. There is no market for FHLBank capital stock other than among FHLBank members. The price of an FHLBank's capital stock cannot fluctuate, and all FHLBank capital stock must be purchased, repurchased, or transferred only at par value. There are no stock options or other forms of stock-based compensation for FHLBank management, directors, or employees.

Broad Participation by a Diverse Membership

The membership of the FHLBanks consists of thrifts, commercial banks, credit unions, insurance companies, and community development financial institutions. At the end of the second quarter of 2013, the FHLBanks had 7,558 members, composed of: 951 thrifts; 5,132 commercial banks;

1,186 credit unions; 273 insurance companies; and 16 community development financial institutions.

The composition of the FHLBank membership closely approximates the composition of the banking industry: 88 percent of members have less than $1 billion in assets compared with 91 percent of all banks and thrifts and 97 percent of all credit unions industry wide. Typically, advance utilization rates are fairly consistent across asset size groups, though smaller institutions are currently funding a larger portion of their balance sheets with advances than larger institutions. Many of these smaller institutions have limited or no direct access to the capital markets other than through their FHLBank.

In addition to depository institutions, over 270 insurance companies are now members of an FHLBank. Insurance companies are significant members of the FHLBanks, representing almost 13 percent of outstanding advances. These members play an important role in the housing market by holding substantial amounts of single and multi-family mortgages and agency debt. Many insurance company members are also active participants in the FHLBanks' Affordable Housing Program (AHP) and the Community Investment Program (CIP) as an extension of their involvement in economic development activities.

The mortgage finance and community lending industry is broad and varied. This variety is crucial to both financial innovation and the diversification of risk across institutions of differing size, geography, charter, and business model. By providing equal access to liquidity, the FHLBanks support the current structure of the industry and this structure can be a source of stability and strength moving forward. As Congress looks to restructure the housing finance system in this country, all member types of the FHLBanks will have an important role to play in meeting the nation's housing finance needs.

Dependable Access to a Deep, Liquid Market for FHLBank Debt

The market for FHLBank debt is one of the most liquid. To the end investor, this liquidity represents an appealing characteristic. Collectively, the FHLBanks issue debt in significant volume on a daily basis. The size, frequency, and consistency of issuance mean that it takes less time for the market to absorb new issues during both normal and stressed markets. In turn, this makes it profitable for dealers to allocate capital against FHLBank underwriting and trading. Greater capital allocations, in turn, mean greater liquidity in the market.

This liquidity enables the FHLBanks to fund at attractive levels across a host of terms and structures. In turn, the FHLBanks pass this advantage on to their members. All members receive the benefit of attractive funding, regardless of their size. Because advances are made at relatively narrow spreads to borrowing costs, attractive issuance levels for FHLBank debt translates directly into lower advance rates for members. In turn, these members are able to pass these benefits on to their communities in the form of affordable credit.

Another benefit of the depth and liquidity of the market for FHLBank debt is that the FHLBanks are able to rapidly scale up their issuance with member demand for advances. The FHLBank debt franchise is well recognized and highly desired by a host of global investors due to its liquidity and credit quality. During 2008 and 2009, against a dislocated bond market, the

FHLBanks were able to increase debt outstanding by $365 billion over 14 months. This added funding provided a lifeline to financial institutions across the country. It is because of the depth and liquidity of the FHLBank debt market that the FHLBanks are able to tap the markets in size when demand surges—even during extreme distress.

Advances and Member Services

Members use advances to fund new originations and existing portfolios of mortgages, to purchase mortgage-backed securities, and to manage the substantial interest rate risk associated with holding mortgages in portfolio. Some members layer in term advances alongside their deposits, altering the duration profile of their liabilities to better suit their assets and mitigate risk. Other members use shorter-term, on-demand liquidity to offset unexpected deposit runoff or to take advantage of an opportunity to quickly add assets. By enabling members to effectively manage their balance sheets, advances lower the cost of extending credit to American consumers.

In accordance with statutory requirements, all advances are secured by eligible collateral and the purchase of capital stock. When FHLBanks issue advances, they lend against both the credit of the member-borrower and the quality of the collateral. Each FHLBank establishes its own processes and procedures for assessing the credit worthiness of borrowers and the appropriate lending value of pledged collateral. FHLBanks regularly monitor actual and potential borrowers' financial condition to ensure appropriate credit actions have been taken to protect the FHLBank against any potential loss arising from any extension of credit. In addition to evaluating members' financial reports, FHLBanks also monitor macroeconomic trends and local laws and regulations, and regularly interact with the member's management teams to ensure they stay attuned to the member's financial condition.

Each FHLBank establishes the types of assets that will be accepted as eligible collateral, defines the specific underwriting requirements and identifies the lendable value that will be applied to each eligible asset. Collateral practices vary among the FHLBanks with regional differences accounting for some of the differences. For example, some districts are dominated by larger commercial banks where others are primarily served by community lenders. Some markets display a concentration of loans exceeding the conforming loan limits, where others are well within the limits. On the coasts, there is a higher concentration of commercial real estate lending, and in the Midwest some institutions specialize in agricultural lending. Based on these regional differences and the risk appetite of each FHLBank, collateral practices will vary. Examples of these variations include, but are not limited to, the types of assets accepted as eligible collateral, the specific underwriting requirements applied to each asset class, the member's collateral reporting requirements, pricing techniques, and on-site collateral reviews.

The valuation and management of member collateral is a process that relies on regional expertise and market knowledge. During a time when many institutions attempted to streamline or outsource credit underwriting and collateral evaluation processes, the FHLBanks stuck to the basics and combined conservative collateral valuation practices with effective credit policies. The FHLBanks have an impressive track record as a result.

Beyond assessments and risk management, FHLBanks provide a variety of member services, such as correspondent services that leverage local knowledge to deliver value. While these services vary across the FHLBanks, it is clear that the strong relationships between FHLBanks and their members are mutually-beneficial and integral to the strength of each cooperative.

FHLBank Mortgage Programs

The FHLBanks have an excellent track record of working with members to manage risk in the mortgage purchase programs that some FHLBanks have administered for over 16 years. In these programs, a participating FHLBank purchases traditional conventional single-family mortgages originated by member institutions under a risk-sharing agreement between the FHLBank and the member. The FHLBanks essentially offer two different versions of mortgage purchase programs. The Mortgage Partnership Finance (MPF) Program generally involves the selling member providing a credit enhancement to the FHLBank that can be called upon if the performance of the pool of loans sold incurs losses above a certain level. The FHLBank of Chicago created the program and administers many aspects of the program for participating FHLBanks. Another MPF variation allows members to sell their loans through their FHLBank to Fannie Mae, although without any risk sharing obligation. The other program is the Mortgage Purchase Program offered by a few FHLBanks that essentially involves the creation of a reserve account against the pool of loans sold by the member that is paid out to the member over time depending on the loss experience of the pool.

The credit quality of mortgage loans funded by FHLBank members has proven to be excellent. The programs have experienced extremely low losses, particularly conventional loans funded through a program that uses a risk-sharing structure that ensures member lenders keep "skin-in-the-game". Of the $202.5 billion in conventional mortgages funded through either the MPF traditional program or the MPP program since their inception, only $303.6 million of losses have been realized, as of June 30, 2013, representing a loss ratio of only one fifteenth of one percent – 0.15 percent or 15 basis points. Only 1.78 percent of these loans were 90 days or more delinquent, or slightly more than half of the national average of 3.24 percent.

The very low level of credit losses (15 basis points) sustained by FHLBanks and their participating members since the beginning of these programs is truly remarkable considering it includes the period of time when the most severe economic stresses in the housing and credit markets in over 80 years were experienced.

These programs are an example of the success that can be achieved from "skin-in-the-game" mortgage partnerships. Community lenders exemplify "skin-in-the-game" business principles on a daily basis—their success is dependent upon being fully invested in the success and survival of the communities that they serve. Prudent underwriting, adequate appraisals, and the provision of appropriate credit products that suit an individual borrower's needs are fundamental operating principles for community lenders.

The FHLBank mortgage programs have been highly successful in adding value to members through product innovation and service. At a time when other secondary market participants are consolidating their services, increasing delivery and guarantee fees and imposing surcharges on

low volume lenders (or providing high volume lenders with discounts), members have recognized that they can rely on their FHLBank to meet their secondary market needs. The mortgage purchase programs allow community financial institutions to be competitive with larger financial institutions and mortgage lenders and to remain active housing lenders within their communities.

Housing and Community Lending Programs

For more than 20 years, the FHLBanks' Affordable Housing Program (AHP) has been one of the largest private sources of grant funds for affordable housing in the United States. It is funded with 10 percent of the FHLBanks' net income each year. These grant funds are distributed through a competitive process to projects developed through partnerships of member institutions and local developers and housing organizations. AHP grants subsidize the cost of owner-occupied housing for individuals and families with incomes at or below 80 percent of the area median income (AMI), and rental housing in which at least 20 percent of the units are reserved for households with incomes at or below 50 percent of AMI. The subsidy may be in the form of a grant or a below-cost or subsidized interest rate on an advance. AHP funds are primarily available through a competitive application program at each of the FHLBanks. AHP funds are also awarded through a homeownership set-aside program to assist low and moderate income households in purchasing homes, with at least one-third of the funds being used to assist first-time homebuyers. The AHP allows for and encourages funds to be used in combination with other programs and funding sources, such as the Low-Income Housing Tax Credit. These projects serve a wide range of neighborhood needs: many are designed for seniors, the disabled, homeless families, first-time homeowners and others with limited resources. As of June 30, 2013 811,542 housing units have been built using AHP funds, including 490,572 units for very low-income residents. The total AHP dollars awarded from 1990 through June 30, 2013 is approximately $4.869 billion.

Each FHLBank also operates a Community Investment Program (CIP) that offers below-market-rate loans to members for long term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods. Members use CIP advances to fund the purchase, construction, rehabilitation, refinancing, or predevelopment financing of owner-occupied and rental housing for households with incomes at or below 115 percent of AMI. The program is designed to be a catalyst for economic development since it supports projects that create and preserve jobs and helps build infrastructure to support growth. Lenders have used CIP to fund owner-occupied and rental housing, and to construct roads, bridges, and sewage treatment plants as well as to provide small business loans. From 1990 to 2012, the FHLBanks' CIPs have lent $68.040 billion for a variety of projects, resulting in 771,684 housing units.

The FHLBanks' Community Investment Cash Advance (CICA) programs offer funding, often at below-market interest rates and for long terms, for members to use to provide financing for projects that are targeted to certain economic development activities. These include commercial, industrial, manufacturing, and social services projects, infrastructure, and public facilities and services. CICA lending is targeted to specific beneficiaries, including small businesses, and households at specified income levels.

In addition to the competitive application program, AHP funds are also awarded through the homeownership set-aside program. Under this program, an FHLBank may set aside up to the greater of $4.5 million or 35 percent of its AHP funds each year to assist low- and moderate-income households purchase homes. Our members obtain the AHP set-aside funds and then use them as grants to eligible households.

Corporate Governance

Congress established a unique ownership and governance structure for the FHLBanks, which has served the FHLBanks well in the past and continues to do so today. A critical feature of this structure is that the FHLBanks are wholly owned by their members/customers so each FHLBank's interests are simultaneously aligned with those of its members and customers. In addition, the boards of directors of the FHLBanks are independent of management. No member of management may serve as a director of an FHLBank.

The Federal Home Loan Bank Act provides that a majority of each FHLBank's directors must be elected by its member financial institutions from among officers and directors of those institutions. Members vote for directors representing member institutions from their states. At least two-fifths of the directors must be independent (non-member) directors. The HERA Act of 2008 altered the governance structure of the FHLBanks to provide for the election of independent directors by the FHLBanks' members, rather than their appointment by the regulator. HERA also required that at least two of each FHLBank's independent directors must represent the "public interest" by having more than four years of experience in representing consumer or community interests on banking services, credit needs, housing, or financial consumer protection. The remaining independent directors must have demonstrated knowledge or experience in financial management, auditing and accounting, risk management practices, derivatives, project development, organizational management, or such other expertise as the FHFA Director provides by regulation.

The Federal Home Loan Bank Act also provides that no member may cast a number of votes in the election of directors greater than the average number of required shares held by members in its specific state. This prevents large members holding relatively large amounts of an FHLBank's capital stock from dominating director elections and, in practice, means that the majority of each FHLBank's member directors generally represent the small institutions that make up the great majority of members.

The statutory framework that controls the composition of the FHLBanks' boards of directors ensures that each FHLBank's board of directors will have a balance of interests represented. With no members of management on the board of directors, directors are in a position to independently oversee management actions. The members that contribute capital and benefit from the FHLBank's products and services are assured a majority of the directors. The director election voting preferences for small members ensure that larger members cannot dominate the board of directors and that an FHLBank's policies will not be detrimental to small members. Finally, the large contingent of independent directors ensures that the FHLBanks will benefit from perspectives and expertise independent of the membership.

Risk Management

The FHLBanks are highly regulated entities, subject to regulation and supervision by the Federal Housing Finance Agency (FHFA).

As 12 independent institutions, each FHLBank is responsible for appropriately developing and implementing its own risk management activities. The cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk profile, and in fact discourages FHLBanks from taking excessive risk. Just as FHLBank members do not expect equity investment returns on their capital stock investments in an FHLBank, they also do not expect equity investment risk in that investment. Members purchase FHLBank capital stock in order to obtain access to FHLBank funding products, and must maintain capital stock investments in the FHLBank as long as they continue to be members. Members provide the capital that supports their advance transactions with the FHLBanks. In this environment, members expect stability, reliability, and consistency of returns and credit product pricing. These member expectations are reflected in the oversight provided by each FHLBank's board of directors, a majority of which is comprised of directors representing member institutions.

Through a rigorous process, each FHLBank continually manages the pool of collateral backing an advance. This includes frequent monitoring of performance, pricing, and valuation. Members are required to maintain a sufficient pool of performing collateral, so they regularly replace delinquent loans and add collateral based on changes in haircuts and valuations. These precautions ensure sufficient overcollateralization at all times.

When an FHLBank lends to a troubled member, it does so in consultation with that member's primary regulator. In the event that the member subsequently becomes insolvent, this process enables the FDIC to minimize losses to the Deposit Insurance Fund. In a liquidation scenario, the FDIC typically pays off outstanding advances in exchange for the timely release of collateral in an attempt to maximize the resolution value of the institution. Should the FDIC opt out of this arrangement, the FHLBank can liquidate the collateral to pay off any advances.

For an FHLBank to take a loss on an advance the liquidation value of a member's pledged assets plus the member's investment in FHLBank stock would have to be less than the outstanding advance plus prepayment fees (the fair value of the advance). This is extremely unlikely— since the establishment of the FHLBanks in 1932, no FHLBank has taken a credit loss on an advance. In the event that collateral was insufficient to cover a defaulting member's borrowings, the next line of defense to FHLBank shareholders would be the failed member's investment in capital stock. This capital is proportional to either the size of the member (asset-based stock purchase requirement) or to the outstanding balance of advances (activity-based stock purchase requirement, which increases along with activity). It is hard to envision a situation in which a member would lose its capital investment in an FHLBank due to the failure of another member.

From the vantage point of debt investors and taxpayers, the FHLBanks' joint and several liability structure provides additional insulation from any loss that might occur at an individual FHLBank. Even if an FHLBank suffers losses, the aggregate amount of capital stock and retained earnings on the balance sheet of the 12 FHLBanks, collectively, would provide a deep

layer of insulation from losses. The combination of the FHLBanks' cooperative structure and the multiple layers of risk mitigation provide an abundance of private capital to buffer bondholders and taxpayers from potential losses.

Financial Condition

The FHLBanks reported net income of $2.6 billion in 2012, up from $1.6 billion in 2011, making 2012 the most profitable year since 2007. For the third consecutive year, all 12 FHLBanks were profitable. As a result of this profitability, the FHLBanks have been able to continue building their retained earnings. As of year- end 2012 retained earnings were at $10.5 billion, having grown 250 percent since 2008 as the FHLBanks prudently strengthened this component of capital as a risk mitigant. Having completed their statutory obligation in 2011 under the Federal Home Loan Bank Act to make payments related to the Resolution Funding Corporation, all of the FHLBanks have entered into a Joint Capital Enhancement Agreement to further strengthen their financial soundness. Under this agreement, each FHLBank, on a quarterly basis, allocates 20 percent of its net income to a separate restricted retained earnings account established by that FHLBank. These restricted retained earnings accounts cannot be used to pay dividends to members and continue to build at each FHLBank until they are equal to one percent of that FHLBank's total outstanding consolidated obligations.

Attachment 2

FHLBank Member Views on Mortgage Markets – Survey Results

Member feedback

The FHLB Des Moines conducted an extensive survey with members during 2013 concerning their present and future need to be active providers of mortgage credit in the communities they serve. The information was gathered to gain a better understanding of members' current mortgage lending activity and to assess their needs in the evolving mortgage market environment to help determine the role FHLB Des Moines could potentially play in a new and modified housing finance system.

Below are key findings:

- Nearly all survey respondents view origination of residential mortgage loans as an important product offering in order to provide a very significant service to their customers. Customer retention, attracting retail deposits, providing all other services and income are the key reasons.
    - An overwhelming number of respondents offer long term, fixed rate mortgages due to customer demand, and most sell those loans to the secondary market rather than retaining them in portfolio.
    - A majority of respondents originate non-secondary qualified type residential mortgage loans and generally hold those loans in portfolio. Most loans held in portfolio are adjustable rate, balloon or shorter term fixed rate loans.
    - FHLB Des Moines advance products and MPF are critically important to members, assisting them to hold loans in portfolio or sell into the secondary market.
- Most respondents sell mortgage loans into the secondary market, including the MPF Programs. They do so primarily to mitigate interest rate risk but many also sell into the secondary market when net interest spreads are too low and/or to manage their volume and portfolio concentrations. Respondents feel that a secondary market is needed for small community banks in order to prevent large banks from completely dominating the markets, and many indicate FHLB Des Moines should be the provider/facilitator.
    - For many, MPF is one of their primary outlets for selling loans into the secondary market. Participation in MPF is a critical component of the member's business model.
    - Convenience, pricing and reliability are the top three reasons members participate in the MPF Programs. Trust and interest rate risk management are also factors.

    - Respondents that participate in the MPF Programs see the main benefits as the opportunity to offer long term, fixed rate loans at very competitive rates, increased profitability and the ability to retain customer relationships.

- A majority of respondents prefer to retain servicing, the primary reason being customer retention. However, due to competition, regulations and a lack of qualified staff, many end up selling the servicing.

    - A number of respondents noted they are evaluating retention of servicing rights due to the cost of the new servicer requirements.

    - When they sell servicing of their loans, they want to be able to sell to a trusted party who will provide excellent service to their customers, but who is not a competitor that might "steal" their customer relationships.

- Complexity and uncertainty surrounding new legislation and regulation brought on by Qualified Mortgage (QM) and Qualified Residential Mortgage (QRM) regulations are among respondent's largest concerns.

    - Approximately half do not see any change in their mortgage business due to new regulation while others anticipate a decrease in mortgage lending activity.

    - Some community lenders are leaving the mortgage business as compliance becomes more difficult and creates additional risk of losses.

    - Many respondents expressed concern that they will no longer be able to provide certain products that meet specialized customer needs due to QM and QRM.

Numerous respondents do not make mortgage loans but take applications and then send the application to another provider in exchange for a fee. Reasons include:

- Lack of a mortgage lending infrastructure

- Lack of capable, trained staff

- Lack of loan volume

- Concerns about regulatory/compliance issues and interest rate risk