

**Testimony of
America's Community Bankers
on
Regulation of Fannie Mae, Freddie Mac
and the
Federal Home Loan Bank System
before the
Committee on Banking, Housing & Urban Affairs
of the
U.S. Senate
on
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and

**Chairman of
America's Community Bankers
Washington, DC**

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee, my name is Harry Doherty, and I am Vice Chairman of the Board of Independence Community Bank Corp., headquartered in Brooklyn, New York. Independence Community Bank is an \$18 billion state chartered savings bank. The bank is regulated by both New York state and the Federal Deposit Insurance Corporation. Independence Community Bank Corp is a thrift holding company regulated by the Office of Thrift Supervision.

I am also Chairman of America's Community Bankers, and I am testifying today on their behalf. ACB appreciates this opportunity to testify on proposals to improve the regulation of the housing-related government sponsored enterprises, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. ACB members include state and federally chartered savings institutions and commercial banks. Our members are comprised of stock, mutual, and privately held companies, and many are specialists in mortgage lending. They are actively involved in the secondary market through Fannie Mae and Freddie Mac and other secondary market participants, and traditionally have been the most active participants in the Federal Home Loan Bank System.

ACB has long supported the secondary market role of Fannie Mae and Freddie Mac. By providing a liquid secondary market for mortgage loans, they have provided great benefits to homebuyers and mortgage originators. We are particularly pleased that they have significantly increased their commitment to community banks over the last several years. ACB helped initiate these changes as the first trade association to enter into relationships with both companies that enable community banks to be more competitive in the marketplace.

ACB members also are the dominant participants in the Federal Home Loan Bank System. ACB members hold more than half of FHLBank stock and take out more than half of the advances provided by the FHLBanks. ACB members also are active participants in the system's acquired member asset programs. These programs were established in the mid 1990's, and have evolved over the past decade as a supplement to the primary advances business of the FHLBanks.

ACB members are very active users of the advances provided by the FHLBanks. Our bank's FHLBank advances total about \$3 billion and represent 19 percent of total liabilities. These advances make it possible for community banks like mine to make sound home loans that may not conform to the strict criteria of the secondary market. FHLBank advances also provide an alternative funding source for community banks that choose to keep loans they originate, whether conforming or not, in their own portfolios. Without access to FHLB advances, my bank could not offer the same range of mortgage products designed to meet the diverse needs of the communities in which we operate.

Legislative Proposals

Last week, a witness before this committee observed that the central purpose of the housing related government sponsored enterprises was to link mortgage lenders to the depth and liquidity of domestic and international bond markets. We completely agree with this statement. Also, each of these unique institutions has excelled in its mission, and is a substantial part of the success of housing policy in this country.

Fannie Mae and Freddie Mac have established and maintained a liquid secondary market for conforming mortgages, primarily through their successful programs of securitizing mortgages to be sold with GSE guarantees to fixed income investors. Through underwriting standards, guarantees and securitization expertise, they have made the domestic and international capital markets willing holders of the mortgage-backed securities (MBS) that put Americans into homes. As result of these activities, we enjoy continuous access to low cost mortgage credit, which has substantially increased our rate of home ownership.

The Federal Home Loan Bank System has linked mortgage borrowers to international capital markets through a different mechanism. FHLBanks have the same access to capital markets that is afforded to Fannie Mae and Freddie Mac. Because FHLBanks can borrow in capital markets on terms better than even the largest banks or savings associations, they are able to offer advances to these institutions at attractive rates, that in turn permit these institutions to continuously offer competitively priced mortgage loans to their customers. Furthermore, these advances can be used to fund any mortgage type, permitting FHLBank System members to offer a variety of mortgage products serving the credit needs of all parts of the communities in which they operate.

Clearly, the continued financial health of all of these entities is critical to ACB members and their communities. Therefore, ACB strongly supports this Committee's effort to improve the regulatory system for the GSEs.

Mr. Chairman, we commend you and the members of the committee for your foresight in drafting and passing a GSE reform bill last year. In light of the problems that have continued to be disclosed about the GSEs, we again support your efforts and the efforts of Senators Hagel, Sununu and Dole. A template is being established that focuses primarily on safety and soundness issues that have become more apparent with the passage of time. Secondly, legislative proposals are addressing mission in a manner sufficient both to ensure that congressional intent to enhance housing opportunities is carried out, and that risk-taking activities not essential to this mission are limited. We also note that a similar positive template is at the heart of the proposals by Chairmen Oxley and Baker in the House of Representatives. These legislative proposals are an excellent starting point to creating a new regulator with much-needed new authorities and powers.

ACB continues to recommend strongly that any GSE reform legislation must establish a strong regulator that:

- Is independent of the political process;
- Has authority to determine its budget outside the Congressional appropriations process;
- Has supervisory and enforcement powers equivalent to those of the federal banking regulators, including ability to set minimum and risk based capital levels.
- Recognizes the unique differences between Fannie Mae and Freddie Mac, which are publicly owned and traded companies, and the FHLBanks, which are cooperatives operating to assist depository institutions fulfill their charter obligations.

ACB is particularly gratified that all of today's legislative proposals on both sides of the Capitol meet these broad criteria. We recognize that certain controversies exist, particularly concerning certain provisions that are new to this year's debate. However, we feel that there is a growing consensus as to the elements necessary to establish a regulatory regime that is not only up to the task of protecting the American public, but equal in stature to the very important GSEs which are to be regulated. For instance, last year the establishment of receivership authority in the new regulator was a highly controversial issue. This year, it seems that much of that controversy has been resolved and a consensus is emerging.

One area where consensus may not exist is in recent proposals to extend the GSE regulatory reform legislation to include the Farm Credit System. ACB strongly supports a review and reform of mission and the regulatory structure of the Farm Credit System. However, we do not believe that it is constructive to attempt that consideration in the context of S. 190 or other bills likely to be before this Committee.

The role of the GSEs is simply too important to our economy, and the failure of any one of them would be too devastating to permit contemplation of anything other than the most capable regulatory regime. We believe the task you have taken up is a critical one that deserves action now. To assist in your consideration, most of the remainder of this testimony will address several issues which we believe are at the forefront of the current debate concerning the future regulation of Fannie Mae and Freddie Mac. It will conclude with a discussion of issues concerning the regulation of the FHLBank System, including our views on misinformation about the System that we feel hampers an adequate understanding of the System and its mission.

Growth Limits and Portfolio Cap

The proposal to establish growth limits and portfolio caps for Fannie Mae and Freddie Mac to contain systemic and specific risks associated with their operations has been most consistently articulated by Federal Reserve Chairman Greenspan, and has also been raised by Treasury Secretary Snow. ACB does not completely embrace these proposals, at least not to their fullest extent.

At the same time, we understand the rationale behind these proposals, and understand that they have some basis, both in theory and practice. For instance, Congress has resorted to similar limits and caps to achieve a variety of public policy purposes. As an example, in the banking system, Congress has established a limit relative to capital on the amount of lending an institution may provide to a single borrower. This constraint limits explicit concentration of risk at a single institution, and also contains systemic risks that would result if concentrations of lending existed at a number of institutions. Congress also has limited the national deposit share that can be held by any single banking institution to 10 percent of total deposits. This limitation has been put in place both for competitive purposes and to help control systemic risk. Finally, the FHLBanks are limited in their investments in mortgage-backed securities to three times capital. This limit was imposed primarily to redirect investments by the banks to mission-related assets that increased lending activities at their member banks, as opposed to arbitrage activities intended only to increase the profitability of the FHLBanks themselves.

A new effective regulator for the GSEs surely must have a range of powers and authorities at its disposal to ensure both safety and soundness and mission compliance. However, effective regulation only results when there is a graduated response by the regulator, sufficient to achieve the desired result, but carefully calibrated to avoid unintended consequences.

Regulatory initiatives that start with or escalate to use of the harshest, most stringent tools available rarely result in the health of the regulated entity or achievement of the desired public purpose. Growth caps or portfolio limits are, by definition, harsh tools, and while there is precedent for their use, the first objective should be to find alternative solutions.

As I stated earlier, ACB believes that the principal benefit provided to housing by Fannie Mae and Freddie Mac has been the bridge they have provided between loan originators and investors willing to hold the assets that originators create and service. We are in agreement with Chairman Greenspan and Secretary Snow that these benefits can be provided at the lowest risk to the enterprises and the economy by guaranteeing mortgage backed securities to be held by fixed income investors. We also agree that holding and funding mortgage assets in portfolio is a much more risky business. Evidence of that fact is directly provided by the much higher capital requirements imposed on my bank, as compared to the capital requirements imposed on Fannie Mae and Freddie Mac for similar activities.

What might be a solution? It would be extremely difficult for Congress to establish an adequate regime based on a rigid ratio or cap that would achieve the desired result. However, Congress could empower a regulator to consider the problem and establish regulations subject to public comment and congressional oversight, and with flexibility to be changed when circumstances warrant. That regulator might also be strongly encouraged to approach this problem with graduated responses designed to avoid unintended harm to a successful housing policy. For instance, a regulator might deal with the risks associated with holding large mortgage portfolios at Fannie Mae and Freddie Mac by changing capital requirements for these activities. This alone may be sufficient to contain any undesirable risk-taking behaviors the regulator perceives.

There may be other types of graduated responses available to the regulator other than using capital controls. Maintaining adequate internal controls, risk assessment capabilities and accounting practices certainly would help to assure that management at Fannie Mae and Freddie Mac have at their disposal all the information necessary to better manage risks and direct the business of the enterprises away from risks that are excessive. Or, the regulator may determine that the business activities of the enterprises need to be conducted in certain proportions to achieve certain mission requirements. By directing one activity in lieu of another, concentration in a particular high-risk business may be avoided.

My point is that only a regulator, properly empowered by Congress, will be in a position to make these judgments, subject to public comment and Congressional oversight. Such a regulator also will be best positioned to adapt regulation based on changing circumstances and needs.

There is a parallel in the debate on caps to the debate last year over receivership authority. Appointing a receiver is a drastic option for a regulator. A regulator does not want to use receivership authority, and would do so only as a last resort in dealing with an insolvent

institution not capable of survival or recovery on its own. However, even though receivership authority might be expected to be used very seldom, if at all, it does make sense that a world-class regulator has this option as a last resort.

Similarly, one would not expect a regulator to resort in the first instance to absolute limits or caps on activities. ACB strongly recommends that the Committee craft legislation that provides the regulator with a range of possible responses, with direction that those responses be graduated in their application so that they are consistent with maintenance of the health of the enterprises, fulfillment of their housing mission and adequate containment of specific and systemic risk. We believe that authority to impose caps and limits should be provided to the regulator, but resort to such a tool be limited to circumstances when all other methods fail.

Bright-line Requirements

ACB has long supported clear requirements that the activities of Fannie Mae and Freddie Mac are restricted to the secondary mortgage markets and subject to effective regulatory oversight. We support language in the so-called “bright-line” section of S. 190 that tasks the regulator with defining the origination function and defining the boundary between the primary and secondary market so that meaningful oversight can be applied with certain essential modifications. We strongly recommend that the section be modified to avoid other unintended consequences that would weaken both the primary and secondary markets.

Paragraph (b)(2) should be modified to reflect the fact that the heterogeneous nature of large multi-family mortgages requires consultation between the lender, the borrower and the secondary market GSE, under the guidance of the lender, prior to closing in most instances.

Paragraphs (b)(3) and (b)(4) should be deleted because they would force the divestiture by the secondary market enterprises of automated underwriting (AU) systems, document and custodial functions that many primary market participants regard as essential services to them especially smaller community banks. Should Fannie Mae and Freddie Mac not be able to offer these services to lenders, the lenders would be forced to seek such services elsewhere. For all but the very large lenders, that would likely mean use of AU underwriting systems provided by large lenders who are in direct competition with the smaller lenders, potentially placing them at a competitive disadvantage. Properly regulated, AU systems offered by the secondary market enterprises would offer an attractive competitive alternative and would not interfere with the lenders’ relationship with customers.

Divestiture of AU systems by the secondary market enterprises would also mean loss of the means to evaluate the risk of loans which comprise the mortgage backed securities (MBS) which they guarantee. The ability to monitor the risk characteristics of the loans, which they purchase and include in guaranteed MBS, is essential to the safety and soundness of the operations of Fannie Mae and Freddie Mac.

Nevertheless, AU systems operated by the oligopolistic secondary market enterprises can and have been a threat to competition. The AU systems can become a channel to control markets and extract excessive gains if they are managed as an exclusive gateway to the benefits provided by

Fannie Mae and Freddie Mac. Therefore, ACB strongly urges the Committee to add language to provide regulatory oversight that encourages market competition for such services and prevents the GSEs from preempting or excluding market competition. Further, ACB recommends that the regulator be directed to prescribe regulations that create a certification process for the enterprises' approval of nonproprietary AU systems on whose results the enterprises will rely.

Guarantee Fees

ACB recommends that the Committee include provisions in GSE legislation to increase transparency in the determination of guarantee fees charged by Fannie Mae and Freddie Mac. We believe that guarantees of MBS create the greatest mission-benefits at the lowest cost and risk to the secondary market GSEs. Because it is the core business for Fannie Mae and Freddie Mac, and because the enterprises have been granted unique market positions by Congress, it is incumbent to create sufficient transparency to maintain competitive markets and the ability of the regulator to oversee the enterprises and evaluate mission compliance.

ACB does not believe that requirements to maintain transparency should be interpreted as a requirement directed toward equal pricing or price fixing. Market participants, in fact, should expect the pricing of guarantee fees to differ based on a variety of factors relating to differing risks and other costs of doing business with different seller/servicers. However, the regulator as well as participants in the market place should have a clear understanding of the factors that affect guarantee fees. In particular, ACB would support annual reporting by the secondary market GSEs of the following information:

- 1) the factors the enterprise used to determine the amount of the guarantee fees it charged;
- 2) the total revenue the enterprise earned from guarantee fees;
- 3) the total costs incurred by the enterprise for providing guarantees;
- 4) the average guarantee fee charged by the enterprise;
- 5) an analysis of how and why the guarantee fees it charged differ from the previous year; and
- 6) a breakdown of the revenue costs associated with providing guarantees, based on product type and risk classifications.

Program, Product and Activity Approval

ACB believes that a strong new regulator is essential to ensure that Fannie Mae and Freddie Mac carry out their secondary market functions and do not migrate into activities outside of their chartered purposes. The most critical consideration for the new regulator in formulating an approval process will be to strike a suitable balance between an approval process that limits Fannie and Freddie to appropriate secondary market functions and a process that hinders legitimate secondary market innovation.

To accomplish this, the new agency must have the authority to review both current and future programs of Freddie Mac and Fannie Mae. They must also be able to prevent inappropriate programs and activities from going forward.

New programs, products, and activities should be subject to an application and approval process. It is important to make the definition of the “programs,” “products” and “activities” broad and inclusive so that the new regulator could review and approve the full gamut of Fannie Mae and Freddie Mac’s new endeavors. We believe that some of the programs launched in the past as “pilot programs” by Fannie Mae and Freddie Mac have been outside the scope of acceptable secondary market functions that were intended by Congress. Therefore, approval should be required explicitly for pilot programs.

We emphasize the importance of new program, product, and activity approval because for over a decade, the Department of Housing and Urban Development has exercised its program approval authority over Fannie Mae and Freddie Mac in a minimal fashion. As a result, Fannie Mae and Freddie Mac have engaged in or attempted to engage in activities beyond their secondary market responsibilities. This approval process should be removed from HUD and the responsibility given to the new regulator.

Though hardly an exhaustive list, we offer the following examples of instances where the GSEs overstepped their boundaries. Both entities have issued retail debt instruments in denominations of as little as \$1,000. ACB believes that it is inappropriate and outside the scope of their charters for Fannie Mae or Freddie Mac to sell retail debt instruments to consumers, either directly or through intermediaries. The sale of small denomination debt to individuals is inconsistent with the purpose for which the GSEs were established. These instruments not only compete for funding sources with insured depository institutions, but they mislead consumers. Third parties have marketed them to consumers with considerable emphasis on their implied federal government backing, when there is no such guarantee. Fannie Mae and Freddie Mac have responded to this problem by improving disclosures. However, we doubt the public is adequately informed and protected. In addition to principal risk, these notes carry interest rate and call risk that relatively unsophisticated investors do not understand. Of course, these risks do not exist for traditional deposit products, such as certificates of deposit. Nevertheless, these small-denomination notes unfairly compete with CDs, weakening community banks’ ability to meet housing finance and other community credit needs.

ACB also is concerned that these debt programs, as well as direct advertising, may have the effect of creating a “name brand” image for Fannie Mae and Freddie Mac in the mind of average consumers. Their extensive retail advertising suggests that this may be a major goal for these entities.

This branding effort could help Fannie Mae and Freddie Mac’s efforts to move into the primary mortgage market. In one example of this, Freddie Mac entered into an agreement with an on-line mortgage company that attempted to reduce primary mortgage originators to, at best, a nominal role in the process. An effective mission regulator is needed to prevent Freddie Mac and Fannie Mae from using their government-provided advantages to supplant private firms that compete in the primary mortgage market.

Housing Goals

In legislation already proposed, Congress has recognized the importance of establishing appropriate, aggressive housing goals for the agencies. We believe the new regulator must be given effective tools to direct Fannie Mae and Freddie Mac to adhere to their mission of fostering affordable housing.

One of the first steps that should be taken to strengthen the affordable housing goals applicable to Fannie Mae and Freddie Mac is to make the definitions of low-and moderate-income applicable to those goals identical to the definitions used in other federal housing programs and the Community Reinvestment Act (e.g., make moderate-income equal to 80% of area median income, not 100%, and make low-income equal to 50% of area median income, not 80%). Among other benefits, this would provide a clearer understanding of how much of Fannie Mae and Freddie Mac's business is devoted to those consumers most in need.

Further, we believe that rigorous but rational housing goals should be imposed on Fannie Mae and Freddie Mac and that those goals should be strictly monitored and enforced. The new regulator should, on a continuing basis, analyze housing needs based on updated information about current primary housing market conditions in order to further refine the GSEs' goals and the process by which they are measured.

Conforming Loan Limits

Conforming loan limits for Fannie and Freddie are intended to limit secondary market activity to loans on moderate-cost homes, based on a national average. We believe it is important for the new regulator to be given authority to use the best national data and indexes available to adjust loan limits to serve moderate-income consumers. We strongly oppose any legislation that changed the method of calculating the conforming loan limit to attempt to address regional variations in housing costs or set higher limits in states with high-cost metropolitan areas. Such changes would serve no public purpose and might undermine Fannie and Freddie's statutory direction to finance housing for low-and moderate-income families, housing in central cities, rural areas, and other underserved areas. Any expansion of Fannie Mae and Freddie Mac into higher cost financing would unfairly compete with the private sector, without offering a commensurate benefit.

Federal Home Loan Bank System

The FHLBank System was established in 1932 as a source of liquidity for savings and loan associations that were the primary home mortgage lenders in America. These institutions were required to be members of the individual FHLBank in their regions and were required to collateralize the advances with home mortgage loans. At the time, these institutions were generally unable to obtain funding by any other means than deposit gathering. Without the System providing advances at reasonable cost to these institutions, millions of Americans would not have been able to become homeowners. In 1999, the System changed again with the imposition of new capital requirements and expanded collateral options. While the focus of many of the members' uses of advances remains mortgage finance, a growing number of advances fund small business and farm loans.

The FHLBank System has grown with the addition of commercial banks and credit unions. The organization and structure of each of the Banks has evolved from an entity that was a regional supervisor as well as a provider of back office services and advances to a System of 12 Banks. What has not changed is the cooperative structure of the System and the requirement that only members can access advances.

The System is a member-owned cooperative that has evolved over time but that continues to provide a necessary source of funds for the majority of its member institutions. Advances make it possible for community banks to make sound home loans that may not conform to the strict criteria of the secondary market. FHLBank advances also provide an important alternative funding source for community banks that choose to keep loans they originate – whether conforming or not – in their own portfolios. Community banks rely on the advance window for borrowing where other funding alternatives are not readily available. In considering the future of the System, from a member and user perspective it is important to retain the highly successful cooperative organization of the System and the ability of the FHLBanks to fund the mortgage originations and community development activities of its member institutions.

As I mentioned, Independence Community Bank is a member of the Federal Home Loan Bank of New York and we have \$ 3 billion of advances outstanding, which comprise 19 percent of our liabilities. We could not offer the mortgage products we do if we did not have access to FHLBank advances. We rely on the FHLBank System day in and day out, and we have as long as we have been a member.

The Relationship Between FHLBank Services and Member Activities

As an indication of the importance of the FHLBank System to the liquidity and funding of community banks, America's Community Bankers has reported that advances comprised 21 percent of the liabilities for member banks active in the System.¹ Further, in the recent Survey of Community Bank Executives conducted by Grant Thornton, 56 percent of the respondents reported that they used FHLBank advances as a source of funding in 2004 and 63 percent expect to use them in 2005, up sharply from 27 percent in 1995 when the survey was first taken.² These numbers confirm the importance of the FHLBank System to a broad base of community banks and are an indication of the evolution of the System in the past 15 years.

Community banks have an acknowledged history of superior performance in lending to low income and minority borrowers. For instance, studies reported by the Federal Reserve have shown that “depository institutions have higher portfolio and market shares than the two for-profit government-sponsored enterprises that are active in the secondary market.”³ These results have been confirmed by similar studies conducted by the Department of Housing and Urban Development. A HUD Working Paper reported that while Fannie Mae and Freddie Mac have improved their affordable lending performance, they “underperform the conventional conforming market in funding mortgages for lower-income borrowers and for properties located

¹ America's Community Bankers, e-Perspective, March 9, 2005

² Twelfth Annual Survey of Community Bank Executives, Grant Thornton, March 2005, p. 13.

³ Volume 82, Federal Reserve Bulletin Number 12: page 1077

in low-income and high-minority census tracts (i.e., underserved areas)".⁴ The FHLBanks support their members' activities in these communities with advances and with programs, including the Affordable Housing Program, which provide any number of examples of successful public/private partnerships.

Community banks also have a strong record of lending to first time homebuyers that has not been matched by Fannie Mae or Freddie Mac.⁵ In 2004, according to a survey conducted by America's Community Bankers, respondents reported that 12 percent of first mortgage loans were made to first time homebuyers.⁶ These activities would not have been possible without the access to advances and the local programs that are made possible because of the FHLBanks.

These data indicate that the services provided by the FHLBanks are closely synchronized to the business activities of their member institutions in all the communities to which they lend. Two studies recently provided to the Committee by the Council of Federal Home Loan Banks indicates this fundamental relationship in striking fashion.⁷ More importantly, the studies convincingly refute suppositions in a study based on 1999 data, and repeated before this Committee just last week, that advances are primarily used to fund jumbo mortgage loans.⁸ This is simply not the case.

The Council studies indicate that FHLBank members are no likely to originate jumbo mortgages than other lenders, and if anything are less likely to originate jumbo mortgages. The jumbo share for FHLBank members was measured at 8.1 percent, compared to 9.4 percent for other lenders. This number is identical to the 8 percent estimate in ACB's 2005 and 2004 Real Estate Lending Surveys.⁹

These dramatically different results are likely the result of several different factors. However, the most important factor likely is that the study is based on 10 institutions primarily operating in California, a high cost market. The sample was not representative of the market, then or now. Also, since 1999, an active "private label" secondary market in jumbo MBS has developed, permitting institutions that might otherwise have been forced to hold jumbo mortgages to sell them, both providing liquidity and reducing interest rate risk. This market innovation also has brought all the efficiencies of securitization to the jumbo market, with out the intervention of government, and to the direct benefit of consumers. The development of the jumbo MBS market is reflected in part by the jump in loan production sold into the secondary market to conduits and wholesalers in recent years. For the three years from 1999 through 2001, only 8 percent of loan

⁴ Bunce, Harold L. 2002, The GSEs' Funding of Affordable Loans: A 2000 Update, Working Paper HF-013, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, abstract.

⁵ *Ib. id.*

⁶ 2005 Real Estate Lending Survey, America's Community Bankers, February 2005, p. 25.

⁷ Courchane, Marsha J and D. Steeg, A Comparative Analysis of FHLBank Member Mortgage Lending, February 25, 2005; and Tuccillo, John A., F. Flick and M. Ranville, The Impact of Advances on Federal Home Loan Bank Portfolio Lending: A Statistical Analysis, February, 2005.

⁸ Pease, J. and J. Miller, III, "Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers," Freddie Mac, 2001, p. 16.

⁹ 2005 Real Estate Lending Survey, America's Community Bankers, February 2005, p. 54; and 2004 Real Estate Lending Survey, America's Community Bankers, February 2004, p. 62.

production was sold to conduits and wholesalers. For the three years from 2002 through 2004, 14 percent of production was sold to conduits and wholesalers.¹⁰

Finally, another measure of FHLBank support for lower-income borrowers can be inferred from the composition of loan production by their members. ACB's 2005 Real Estate Lending Survey indicated that loan production was broken down as follows: 81 percent was conforming, 8 percent was jumbo, 1 percent was alternative-A (regarded as conforming or near conforming), 1 percent was subprime, 1 percent was FHA/VA, and 7 percent was other non-conforming.¹¹ Only the subprime and other non-conforming did not have ready secondary market options, and therefore had to be funded in portfolio. The other non-conforming portion is comprised of loans with a variety of non-conforming factors such as high loan-to-value ratios, poor or minimal credit histories, and similar issues. Not surprisingly, many lower income borrowers find themselves in this category, at least temporarily, and many are first time homebuyers. Without strong advance programs and AHP, member banks like mine could not have as strong a performance record in lower-income communities as we have proudly been able to achieve.

Key Factors in Regulatory Reform

As a member of the FHLBank of New York, the safe and sound operation of the Bank and the safety of my investment are critical. As a banker, I understand the importance of good supervision and oversight for both safety and soundness and mission. ACB supports an operating model for the FHLBanks that is founded on the current statutory authorities and a strong regulator that provides oversight. Because of the cooperative organizational structure and the joint and several liability of certain activities of the Banks, I am interested in the activities of all of the FHLBanks and how those activities could affect my investment and my ability to obtain funding.

As the debate progresses, and Congress considers the concerns common to the FHLBank System and the GSEs, we urge you to ensure that the legislation provide a new regulatory structure that recognizes the unique and successful business model of the FHLBank System. Any revised regulatory system should continue to respect the organizational differences, while advancing the common goal – to maintain their financial safety and soundness.

In the mid 1990's the FHFB, working with several of the FHLBanks, developed mortgage programs that are generally referred to as acquired member asset programs. Currently there are two programs, the Mortgage Partnership Finance and the Mortgage Purchase Program. These programs were developed to provide the members and the Banks that participate an alternative risk management and mortgage funding strategy. The members are able to sell loans to the FHLBank under terms established in the programs.

As the programs evolve to meet needs of the Banks that developed them and the members who use them, some market participants have discussed permitting securitization of the loans as part of the programs. Presently, there are no proposals from the Banks before the FHFB to permit such securitization. ACB strongly believes that the issue of securitization must be studied before

¹⁰ 2005 Real Estate Lending Survey, America's Community Bankers, February 2005, p. 9.

¹¹ *Ib. id.*, p. 54.

any action is taken, and that securitization be considered only in the context of a public review process conducted by the designated federal regulator.

The FHFB has evolved as a regulator. In the past few years, a greater emphasis has been placed on the safe and sound operation of the Banks and on the supervision of the System. The examination staff has grown in number as well as in expertise as a reflection of the greater understanding of the importance of having a strong regulator. Any legislation must continue this trend.

The FHLBanks, out of the proceeds from net income, operate statutorily mandated affordable housing programs and are responsible for paying off the RefCorp bonds that were used to help resolve the 1980s savings and loan losses. Each FHLBank is primarily capitalized through the required purchase of stock by its member institutions. FHLBank stock is not available to the public and is not tradable, even within an FHLBank without the express permission of the FHLBank. The stock is issued and redeemed at a par value of \$100 and does not fluctuate in value.

The cooperative structure of the System is essential to preserving the benefits that member institutions provide to communities and families and fund through advances. One of the many strengths of the System is the ability of each of the 12 Banks to develop and tailor products that meet the changing and diverse needs of their own members. Advances are used to fund loans that may not be conforming loans that the member institution may retain in portfolio.

The FHLBank System needs a strong, independent regulator that has the authority to supervise the individual Banks using the current statutory framework of powers. Any new regulator of the FHLBanks must have the authority to maintain the Banks' access to the capital markets and their current well-defined mission to support the mortgage finance, affordable housing, and community development activities of member banks. The advance programs of the FHLBanks ensure that homebuyers and others in the community have ready access to home mortgage and community financing through FHLBank members. The fact that the FHLBank System members are the leading lenders to lower income and minority borrowers is testament to the success of the System and its mission.

The new regulator must be sufficiently flexible to address and accommodate the differences in business strategies and operations that were permitted under the Gramm-Leach-Bliley Act and now exist among the FHLBanks. The new regulator must also work within the current statutory authorities, which include safety and soundness and mission oversight. It is also critical that the financial obligations imposed on the Banks by Congress can be met.

In 1989, two assessments were placed on the earnings of the System. The first, the Affordable Housing Program, is funded out of contributions from the net income of each FHLBank. The total contribution from all Banks is required to be 10 percent of net income or such other amounts that in the aggregate equal at least \$100,000,000 each year. This money is then allocated based on an application process developed by the FHFB. The projects that receive funding include many housing and community development projects. This program is a good example of how special affordable housing and community partnerships can be funded by an

assessment on the System. We would not support a change in the way the very successful AHP works.

The second assessment on the System is the obligation toward repayment of the interest on the RefCorp obligations. Each bank must pay an amount equal to 20 percent of net earnings to repay the obligations incurred in the 1980's. These assessments are a legacy obligation of the System and are part of obligations that Congress imposed on the System, along with other mission requirements.

Congressional efforts to strengthen the regulation of the FHLBank System are important, but it is important to recognize that improvements are expected primarily from synergies and expertise that should be available in a new regulatory structure. The current regulator has broad powers to promulgate and enforce all regulations and orders as are necessary from time to time to carry out the provisions of the statute. It is important that the new regulator effectively exercise this authority to ensure the safe and sound operation of the Banks and to preserve the core mission of the System of providing liquidity to community banks. The characteristics for any new regulator must include that the regulator must:

- Possess similar supervision and enforcement powers to those of federal banking regulators to maintain safety and soundness and guard against systemic risk;
- Be organized with a strong emphasis on preserving the current statutory authorities and the cooperative structure of the System;
- Recognize the unique characteristics of the System; and
- Not impede or limit the FHLBanks' access to the capital markets.

The FHFB has powers and authorities similar to those of the banking regulators in the areas of capital, activities and supervision. Such authorities should be preserved and to the extent that efficiencies can be gained by combining supervision in discreet areas, the regulator must recognize the differences in the regulated entities. Substantive areas in which there may be synergies include interest rate risk management and accounting guidance.

A review of the structure and powers of the regulators is important. It is also critical that as the System evolves, the regulator, the members, the analysts, the purchasers of the debt and other interested parties be able to have access to information about the Banks.

The FHLBanks' stock and debt instruments should be subject to, transparent disclosures that are appropriate for this unique GSE. In June 2004, the FHFB issued a final rule requiring that each Federal Home Loan Bank register a class of securities with the SEC under the Securities Exchange Act of 1934. The disclosure scheme that has been established for public companies contains a number of requirements with which it is difficult for a cooperative System to comply. ACB support the inclusion of certain specific securities law exemptions in any legislation. Such provisions will facilitate registration and compliance with the disclosure requirements, and will also make it easier for interested parties to understand the disclosures and the business of the FHLBanks.

As part of SEC registration, each of the Banks must comply with a number of provisions of Sarbanes Oxley, including Section 404. Each FHLBank is developing the systems, policies and procedures necessary to comply with the internal control requirements. In addition, each FHLBank is drafting disclosures that must be included in the registration statements regarding financial information, operations and corporate governance. Each FHLBank is ensuring that its staff has the expertise necessary to draft the disclosures and to meet regulatory requirements.

Going forward, the public nature of the disclosures and the transparency that results from the ongoing reporting requirements will result in a better understanding of internal controls, corporate governance, and financial condition of each of the FHLBanks and the System as a whole.

The current corporate governance structure of the FHLBank System has been established by statute. Over the years certain governance functions have been devolved from the regulator to the FHLBanks themselves. We believe that the composition of the Boards of each of the FHLBanks is a critical element in ensuring that the governance of the FHLBank is undertaken in an appropriate manner. As each of the FHLBanks, and the System in general, has evolved into more sophisticated financial institutions, we believe that financial, business and operating expertise must be demonstrated by the Board of each FHLBank. We support careful consideration of changes to the statute, regulation, and practice that will ensure that each FHLBank will have a Board that is composed of members with a stake in the System who understand the commitment and importance of serving on a FHLBank Board. As the financial structure of the Banks becomes increasingly complex, it is important to have strong financial qualifications for all directors so that they can effectively oversee the FHLBanks' operations.

Conclusion

In conclusion, we believe that it critical for any new regulator to be independent of the political process; have authority to determine its budget outside the Congressional appropriations process; have strong supervisory and enforcement powers, including ability to set minimum and risk based capital levels; and recognize the unique differences between Fannie Mae and Freddie Mac, and the FHLBanks.

I wish to again express ACB's appreciation for this opportunity to testify on these important issues. We strongly support the committee's effort to strengthen the regulation of Freddie Mac, Fannie Mae, and the Federal Home Loan Banks. We look forward to working with you and your staff as legislation moves to accomplish this goal.