



Testimony of
INDEPENDENT COMMUNITY BANKERS OF AMERICA

on
“Proposals for Reforming the Regulation of the
Government-Sponsored Enterprises”

US Senate Committee
on
Banking, Housing, and Urban Affairs

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Introduction

Chairman Shelby, Ranking Member Sarbanes and members of the committee, my name is David E. Hayes, I am President and CEO of Security Bank in Dyersburg, Tennessee, and I am pleased to testify today in my capacity as Chairman of the Independent Community Bankers of America (ICBA). ICBA appreciates this opportunity to testify on proposals to improve the regulation of the housing government sponsored enterprises, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Before I begin my testimony, I want to acknowledge Senator Sarbanes' announcement of his plan to retire at the end of the current Congress. We at ICBA have long supported his tireless fight to maintain the separation of banking and commerce. While not a high-profile issue for the press, keeping commercial firms out of banking is essential to maintaining our diversified financial system and providing objective sources of credit for small businesses, consumers, farmers and ranchers. Senator Sarbanes, ICBA will miss your voice in the Senate.

Core Values

Mr. Chairman, the core values of ICBA community bankers are embodied in the underlying principles of our association. ICBA supports the dual banking system and the preservation of fair competition in financial services; we support maintaining the separation of banking and commerce; we believe in a balanced financial system that does not favor any segment of the financial services sector and we oppose the concentration of economic and financial services resources; our institutions create symbiotic relationships with the communities they serve; we favor local decision making while adhering to the highest business practices and ethical standards; and we support a democratically governed association where each member bank has a voice and a vote.

ICBA Supports Improved GSE Regulation

ICBA strongly supports efforts to improve the regulation of the housing GSEs. These institutions are vital to thousands of our nation's community banks. Like many community banks, Security Bank has greatly benefited by a robust secondary market, which enables us to sell mortgages and invest in mortgage-backed securities.

Though very different in key respects, all three of the GSEs provide community banks with irreplaceable access to the capital markets. This access allows our members to offer the same home mortgage products to our customers that the largest firms offer to theirs. In addition, the FHLBanks provide members

advances for liquidity and asset/liability management. Thus, the GSEs need a strong, independent safety and soundness regulator to ensure they remain reliable sources of funding and liquidity for decades to come.

Chairman Shelby, I would like to commend you for your leadership last year in advancing GSE reform legislation that cleared this committee by a 12-9 vote. Your bill contained many positive features including the creation of a world-class independent regulator, recognition of the unique structure and mission of the Federal Home Loan Bank System, and protection of the GSE status of the enterprises, which is so vital to ensuring the stability of the U.S. housing markets.

In addition, your legislation contained two amendments offered by Senator Enzi. The first clarified that the mission of the Federal Home Loan Banks includes providing liquidity and economic development funds to community financial institutions to serve their small farm, small agri-business and small business customers. We strongly urge that this amendment be incorporated into your bill. The second required that a study on limiting depository institutions' investments in GSEs also take into account what other investments would be available to replace those investments. If there is a study in your legislation on limiting depository institutions' investments, then we urge that this amendment be included as well.

Because the GSEs are so important to community banks and their customers, ICBA urges Congress, in the strongest possible, terms to reject proposals that claim to improve GSE regulation but are actually designed to undermine their mission or pave the way for privatization. The mortgage marketplace already includes large private lenders that combine wholesale funding with aggressive national retail marketing. The housing GSEs make it possible to combine wholesale funding and community bank service at the local level. Rather than take any steps to undermine this unique mission, we recommend that Congress improve and enhance it by establishing a strong, independent regulator focused on safety and soundness.

There are a variety of ideas that could disrupt the functioning of the GSEs. One of the most recently suggested is somehow imposing a cap on their growth or size. ICBA strongly opposes the placement of arbitrary caps that are designed simply to limit GSE portfolios without regard to the varying needs of consumers over time. We believe that the GSEs should be able to operate within their mission without artificial limits. On the other hand, we understand that the regulator may need to impose growth limits for safety and soundness purposes. I will get into this in more detail later in my testimony.

Structure of the Regulator

ICBA has long supported world-class, independent regulatory agencies, such as the Federal Deposit Insurance Corporation and the Federal Reserve, which are governed by boards independent of the Department of Treasury. These agencies have worked effectively. Following that same model, ICBA believes that the GSEs' safety and soundness regulator must be independent of political influence. The Treasury Department—whose primary responsibility is the fiscal policy of our country—should not direct the nation's housing policy, just as it should not direct its monetary policy, because doing so would create a conflict with Treasury's primary purpose.

While ICBA has had misgivings about including the FHLBanks within the new regulatory structure, we recognize that there is a consensus to do so. If Congress creates a new agency to oversee all three housing GSEs, that agency must be structured and directed to maintain the cooperative ownership structure, operations, and mission of the FHLBanks. Though they share some characteristics with Fannie Mae and Freddie Mac – primarily their substantial borrowings in the capital markets – the cooperatively owned FHLBanks are very different from the publicly traded housing GSEs, Fannie Mae and Freddie Mac. In addition, the FHLBanks' primary mission is to provide advances to their members for liquidity and asset/liability management. FHLBank advances enable them to make and hold mortgages and other types of loans in their own portfolios—loans that generally do not qualify to be securitized. Unlike Fannie Mae and Freddie Mac, the FHLBanks do not securitize mortgages and sell them to the public.

We prefer that the Department of Housing and Urban Development continue to oversee the program authority of Fannie Mae and Freddie Mac. We view this as a matter of housing policy, rather than a safety and soundness issue. While regulatory oversight of programs is appropriate to ensure that they fall within the GSEs' mission and can be conducted in a safe and sound manner, a balance must be struck between the needs of a regulatory approval process and the need for the GSEs to have flexibility to respond rapidly to evolving consumer and marketplace demands for new products and programs.

Powers of the Regulator

Congress also should be cautious with respect to the powers that it confers on the new regulatory agency and its director. As a general rule, we believe that the powers of the new GSE regulator and its director should not surpass those at Federal banking agencies, particularly since the director will be operating independent of a board with executive authority. Given the enormous powers that have been discussed in the GSE debate, a director would be able to exercise significant political influence over the program and policy direction of the

agency. The banking regulator model has worked well over the years, and Congress would be well served to take this into account.

Powers of the GSEs; FHLB Securitization

ICBA believes that the fundamental purpose of this legislation is to enhance the safety and soundness regulation of the housing GSEs. Just as it should not be a roadmap to privatization, it should not be a vehicle for fundamental reductions or enhancements to their authorities. The GSEs have their mission -- enhancing housing finance, and, in the case of the FHLBanks, supporting small business, agricultural, and community development lending. The GSEs have been a resounding success in fulfilling their housing mission. In this critical respect, they are not broken and don't need fixing.

By the same token, the accounting and management of at least Fannie Mae and Freddie Mac have shown significant weaknesses in recent years. The FHLBanks have had some difficulty as well. Congress clearly needs to strengthen their regulatory oversight, to ensure these problems are not repeated, while maintaining the basic mission and structure of the GSEs.

For example, Congress should not use the current legislation in our view to significantly increase GSE powers, such as authorizing FHLBanks to securitize mortgages. Some community banks currently use the mortgage purchase programs offered by the FHLBanks and find them beneficial. We recognize the argument that securitization by the FHLBanks could increase competition with Fannie Mae and Freddie Mac, leading to lower guarantee fees paid by lenders to the GSEs and lower costs to borrowers. We also recognize the argument by some FHLBanks that expansion of these programs into securitization could well result in increased profits and increased member dividends. But we also recognize that with increased profits can come increased risk to the FHLBanks and the system.

ICBA has does not at this time have a view as to whether or not the FHLBanks should have the authority to securitize residential mortgages, or any other type of loan, over the long term. Giving the FHLBanks the authority to securitize mortgages could dictate the development of a very different business structure than their current one that is focused on providing advances. We believe that this is an issue that needs significant study and debate by members and other affected parties to first determine if the FHLBanks should enter this business and second how best to conduct it given the system's structure. Some are urging Congress just to clarify that the regulator has the authority to determine whether the FHLBs can or should securitize member assets. We would oppose this. The magnitude of change that this might bring to the system is of such degree that it should be Congress that makes the decision, after a thorough study.

Secondary Versus Primary Market Activities

Congress should not attempt to draw a “bright line” between primary and secondary market activities of Fannie and Freddie. Section 107 of S. 190 attempts to resolve this long-running controversy by providing that “underwriting a loan for origination, directly or indirectly, is a primary activity” (Emphasis added) Frankly, the workings of the modern mortgage market are not as tidy as these provisions suggest. Primary lenders like community banks have found great value in the automated underwriting systems (AUSs) devised by Fannie Mae and Freddie Mac. Automated underwriting systems enable community banks to quickly and objectively qualify a borrower for a mortgage and determine if that loan is saleable. Similarly, the enterprises are developing automated appraisal systems (AAPs). We anticipate that AAPs will affect property underwriting in the same way AUSs have aided credit underwriting: drive down lender and borrower costs, expand approvals (an ongoing problem with rural properties), and increase standardization.

Standardization is one of the major contributions that the GSEs have made to mortgage lending. It has leveled the playing field between the largest and smallest lenders, providing consumers more choice and better service. Without this standardization, a community bank would be forced to choose a single secondary market outlet for the loans its originates, rather than being able to seek the best pricing for its customers. Thus, the GSEs are expediting and reducing cost in the primary loan process. They are not interfering with or controlling the borrower.

Limits on Growth

ICBA strongly opposes the placement of arbitrary, statutory caps on the portfolio size of the housing GSEs. The GSEs must have the flexibility to expand and contract to meet the needs of the mortgage industry and ultimately consumers. Should statutory limits be placed on the GSEs, they may not be able to provide liquidity to lenders to meet heavy consumer demands for mortgages to buy new homes or refinance existing mortgages.

We are also concerned that should statutory limits be placed on growth, Fannie and Freddie would be compelled by business reasons to give preference to their large volume customers. Under that scenario, community banks with relatively low origination volumes -- some as low as one or two mortgage loans a month -- would be shut out and not have a secondary market outlet. Under current rules, Fannie and Freddie can buy these loans for their own portfolios. Capping the GSEs' portfolios would seriously hamper the ability of our members to serve the mortgage needs of their customers.

I think it is also important to note that, from a macro perspective, placing limits on portfolio growth could make it difficult to raise the roughly \$1 trillion in mortgage funding needed each year to assure stability in the housing markets. To help raise these funds, the market needs to attract investors from all over the world. Many foreign investors are reluctant to invest in mortgage-backed securities because of an aversion to prepayment risk. As an alternative, such investors may be attracted to debt securities. Limiting the options of investors could jeopardize the stability of the housing market and hurt the next generation of homebuyers.

We recognize that there are options being considered that would grant the new regulator certain powers to restrain portfolio growth. We strongly caution against granting the new regulator overly broad authorities to limit growth except when it is needed to ensure the safety and soundness of the enterprise. The GSE regulator should have supervisory and examination tools, comparable to bank regulators, to control growth for safety and soundness reasons. Growth limits should not be used as a tool to implement political ends. We are concerned that overly broad authority to limit growth may become politicized, and subject to undue political interference. Therefore, any growth limit authority should be carefully crafted. As a general rule, we believe the new GSE regulator should have the same powers as bank regulators, not more.

Capital

The new GSE regulator also will be able to regulate growth for safety and soundness reasons through adjustments to risk-based capital. ICBA has preferred to keep in the hands of Congress control over the statutory or minimum capital standards for Fannie Mae and Freddie Mac, as currently is the case, due to concerns that should a new regulator lack sufficient independence, it could de facto adjust program levels by raising minimum capital, reducing the amount of resources available for housing. This would give the regulator a degree of authority over housing levels in the United States that we feel is inappropriate. In establishing the housing GSEs, Congress made the determination that housing is of sufficient importance in the economy and society that it should receive this special support. We have been concerned that support of housing could be significantly altered as the regulator changes with the administration. We do not see it in the best interest of our country's well being to expose housing to this potential volatility.

A strong, independent regulator should have the authority, consistent with the current authority of banking regulators, to establish, and modify, as necessary, risk-based and minimum capital the GSEs must hold to ensure their safety and soundness. Capital levels should not be used to advance political policy.

Receivership

Placing a GSE in receivership should only be considered when the GSE reaches certain criteria related to its financial condition or for other safety and soundness reasons, comparable to those governing the receivership of insured depository institutions. Receivership should not be considered for political policy reasons. For this reason, it is our strong preference that Congress retains final authority over the regulator's receivership powers regarding Fannie Mae and Freddie Mac to ensure that receivership is not used for political purposes.

Community banks hold significant amounts of securities issued by the GSEs and they have limited investment alternatives due to regulatory constraints. GSE debt is also widely held by institutions and individuals domestically and abroad who seek low risk investments. Investors have purchased these securities under the current legal framework. Congress should take care when considering new receivership authorities so as not to cause a sudden significant deterioration in the value of these securities and lowering of credit ratings by rating agencies.

Mission of the FHLBs

ICBA believes that Congress should set the specific missions for GSEs, including the FHLBanks, Fannie Mae, Freddie Mac and the Farm Credit System, and that the regulator should ensure that they are meeting their mission. The current statute refers to the fact that the FHLBanks have a "housing finance mission." This should not change. But in the Gramm-Leach-Bliley Act of 1999, Congress allowed FHLBank members that qualify as Community Financial Institutions to use long term advances for small businesses, small farms and small agribusinesses (and pledge loans to small business and agriculture as collateral), thereby expanding the mission of the FHLBanks beyond housing. While some FHLBanks moved forward rapidly to help their members serve small businesses and agriculture, others have not. This is the rationale for the Enzi amendment I referred to earlier -- to clarify this expanded mission. We do not think Congress envisioned these new authorities would be implemented in only certain FHLBank districts. The vast majority of Community Financial Institutions cannot pick and choose which FHLBank to take their business to, unlike the largest banking companies that have charters in more than one FHLBank district. Thus, we believe Congress should not provide the FHLBanks additional authorities, such as to securitizing mortgages, until expanded authorities provided by the Gramm-Leach-Bliley Act are implemented by all FHLBanks.

Office of Finance

ICBA would have no objection to restructuring the FHLBanks' Office of Finance into a corporation owned and capitalized equally by the FHLBanks, with each FHLBank given a seat on its board of directors. The FHLBanks' regulator should have full examination authorities over the corporation.

FHLBank Individual Debt Issuance

Currently the FHLBanks are authorized, subject to rules and regulations established by their regulator, to borrow and to issue debentures, bonds and other obligations, in addition to issuing consolidated obligations. We believe it is necessary and appropriate in the ongoing conduct of business for individual FHLBanks to have authority to issue some debt as an individual entity. However, this function should continue to be regulated, supervised and examined by the regulator. The regulator should not look at the issuance of debt by an individual FHLBank in isolation, but also its effect on other FHLBanks and the system as a whole, due to joint and several liability. This is of particular importance since FHLBanks do not have full information about all aspects of each other's business activities.

FHLB Multidistrict Membership

ICBA opposes permitting financial institutions to belong to more than one FHLBank using a single charter (multi-district membership). The current structure of the FHLBank system has worked well and there is no compelling reason to make changes in membership rules. The issues surrounding multi-district membership through a single charter are complex and many affect the FHLBanks' safety and soundness. Such membership could also undermine the existing regional structure.

Consolidation

ICBA also opposes consolidation of the FHLBanks. We recognize that consolidation in the banking industry has significantly affected the FHLBanks. Some FHLBanks have grown, while others have shrunk. This trend may well continue. As a representative of nearly 5,000 community financial institutions, nearly all members of FHLBanks, I'm here to tell you bigger is not necessarily better. Community banks put a high value on the regional structure of the FHLBanks that exists today because it reflects their regional diversity. Consolidation should only be considered by the regulator in the event that a FHLBank faces financial difficulties of such a magnitude that it can no longer maintain independent financial viability. Any consolidation not due to financial difficulties must be member driven and member approved since the members are the owners and users of the FHLBanks.

Concentration in the FHLBank System

Concentration in borrowing through advances by the FHLBanks' largest members is of concern to ICBA. ICBA believes that the system's regulator should address this before a serious problem arises, such as default of a member that is a dominant advance borrower (and capital provider) or the loss of their business to another funding source. The regulator should establish

concentration limits for advances for both individual FHLBanks and the FHLBank system to protect safety and soundness.

FHLB Affordable Housing Program

Some have suggested that statutory changes are needed to correct the skewing of allocations of Affordable Housing Program funds that has occurred due to consolidation among FHLBank members. The concern is that, in cases where a major member operates in more than one FHLBank district, earnings on those operations will be attributed to only one of the FHLBanks. We believe that this can and has been addressed by some FHLBank districts by their boards of directors. In our view, addressing this by regulation or by FHLBank policies is preferable to statutory changes and provides necessary flexibility to meet changing industry needs.

Affordable Housing Goals for the FHLBs

We have heard suggestions that perhaps the FHLBanks should be subject to goals for the purchase of mortgages from low-and moderate-income individuals and certain other targeted populations and areas as are Fannie Mae and Freddie Mac. We have also heard the suggestion that these goals should be applied to advances. ICBA is opposed to this for several reasons. First, the FHLBanks currently pay 10 percent of their earnings into their Affordable Housing Program that goes directly to providing affordable housing. It is easy to track how the AHP funds are used. Second, we have witnessed extensive debates between Fannie Mae and Freddie Mac and HUD, the agency that sets their goals, over how the goals are determined, performance is measured and whether they are meeting their goals despite extensive regulations. In our view, it is unnecessary to impose this burdensome, costly process on the FHLBanks when their AHP programs and contributions are already meeting these obligations.

We also strongly object to imposing housing goals on the use of advances. The vast majority of FHLBank members are subject to the Community Reinvestment Act and regulatory oversight to ensure they are promoting affordable housing and serving low- and moderate-income customers. Again, this would be a significant additional and redundant regulatory burden on the FHLBank members and their customers.

SEC Registration for FHLBanks

The Federal Housing Finance Board has adopted a regulation that requires the FHLBanks to register a class of security with the SEC. ICBA and other representatives of FHLBank members have been deeply concerned that this requirement could disrupt the FHLBanks' ability to borrow funds. It is critical that the requirements of SEC registration not impede the FHLBanks' ability to issue consolidated obligations so that they can continue to provide liquidity to their members without interruption.

The Council of Federal Home Loan Banks has recommended a number of statutory adjustments that will ensure that SEC registration does not disrupt the FHLBanks' borrowing, while maintaining the goal of greater transparency for those who invest in System debt. Many of these recommendations, which we support, are included in S. 190.

In addition, legislation should direct the SEC to ensure that it takes all possible steps to avoid unnecessarily impeding the FHLBanks' capital market access. The bill should also require that SEC to consult with the new regulator on an ongoing basis and share information in the same manner as required by the Gramm-Leach-Bliley Act with respect to banking regulators.

Needed Adjustments

While Congress need not, and should not, undertake fundamental changes to the structure and mission of the housing GSEs, several issues have arisen since Congress considered legislation in this area, particularly regarding the FHLBank System. We believe Congress can usefully address these concerns without getting bogged down in needless controversy.

FHLBank Mission is Expanded by G-L-B Act. As mentioned in my opening remarks, ICBA recommends that your bill include Senator Enzi's amendment regarding mission that was included in last year's bill. The amendment made clear that the mission of the FHLBanks includes providing support for small farms, small agribusiness, and small business financing, pursuant to the new Gramm-Leach-Bliley Act authorities. Including this explicitly in the mission would encourage FHLBanks to implement their authority as originally intended. We also would strongly support raising the maximum asset size for designation as a Community Financial Institution to \$1 billion (with annual adjustments). We believe that this increase will allow more FHLBank members to promote economic development in their communities by accessing funds for lending to small farms, small agribusinesses and small businesses and pledging those loans for collateral. Hopefully, this will encourage FHLBank to move more aggressively to implement their authorities to serve CFIs.

FHLBank Public Directors. The current system of appointing public interest directors by the Finance Board is another recent area of concern. Federal Housing Finance Board Chairman Ronald Rosenfeld has testified that this method is flawed. He believes that public interest directors should be selected on the basis of their expertise and ability to improve the boards' function, rather than for political or other reasons. We agree.

ICBA supports giving each FHLBank the authority to select a minority number of public interest directors, nominated by the board of directors and elected by members. In this manner, public interest directors can be selected to meet the particular needs of each FHLBank, not just to repay political favors, as has sometimes been the case. Selection of public interest directors by members rather than the regulator also enhances the independence of the regulator from the governance structure of an institution it regulates.

No changes should be made to the election and voting process for directors representing members, as we believe that it is working well. Members must retain a majority of director seats to reflect their ownership.

Compensation

In general, ICBA believes that it is proper for the boards of directors of the GSEs to set compensation policies. We also believe that Congress should consider removing limits on compensation for FHLBank directors. Their compensation was cut in 2000 and we think that Congress should reconsider levels so that FHLBanks are able to attract people of significant technical expertise to serve as directors. The regulator should promulgate regulations to guide boards in appropriately setting compensation policies. In setting compensation for the leaders of Fannie Mae, Freddie Mac and the FHLBanks, we recognize a balance must be maintained that reflects that these are GSEs conducting a public purpose, yet they are very complex financial institutions that need to attract highly skilled leaders.

Farm Credit System

Since Congress is now debating significant regulatory reforms to the regulatory oversight of Fannie Mae, Freddie Mac and the FHLBanks, it is a good time to look at the oversight of another GSE, the Farm Credit System. Unlike the other GSEs under discussion, the Farm Credit System engages in direct retail banking activities, competing directly with community banks.

We have seen the Farm Credit System engage in significant mission creep and it clearly needs a stronger regulator to ensure that it is adhering to its congressionally mandated mission. The regulator of the Farm Credit System must be made more independent and transparent, with enhanced risk assessment capabilities. To address these issues we have urged that the current FCA board be expanded by adding two new, independent board members that have no current or past affiliations with the FCS. One of the two new board members would have expertise in managing financial risks in complex financial institutions to address growing financial market sophistication. The FCA is also the federal regulator for Farmer Mac, the secondary market for agricultural real estate and rural housing loans.

The enhanced board structure would also allow greater public transparency into FCS activities. The FCA is considering a number of scope and eligibility expansions of the FCS's lending authorities that clearly encroach into market activities that are more than adequately served by private sector institutions. Therefore, we believe the enhanced FCA board structure would help ensure that private-sector institutions are not unfairly disadvantaged in the marketplace by a government sponsored enterprise that desires growth at the expense of the private sector.

The FCA must be reformed to ensure the FCS's original mission is strictly adhered to, and that adequate safety and soundness mechanisms are in place. Public transparency of FCS activities must also be ensured. Farmer Mac would also benefit from enhanced regulatory oversight. Congress should not overlook this extraordinary opportunity to reform the regulator of the FCS. ICBA has communicated these views to the House and Senate Agriculture Committees, strongly urging them to address these issues just as the banking committees are looking at regulatory reform of the GSEs under their jurisdiction.

Conclusion

ICBA strongly supports efforts to improve the regulation of Fannie Mae, Freddie Mac and the FHLBs to ensure their long-term health and stability. Access to these GSEs is vital to the ability of community banks to provide financing options for housing, small businesses and agriculture. Many community banks rely on FHLBank advances for liquidity and asset/liability management. In this regard, ICBA strongly opposes changing the GSE status of the enterprises that ensures capital market access.

As a general principle, the GSE regulator should have the powers held by banking regulators to supervise and examine insured depository institutions to ensure safe and sound institutions. The regulator must be independent of political influence. Its role should be to ensure the safety and soundness of the GSEs and to ensure they achieve their missions, but not to set policy for national homeownership levels.

Thank you, Chairman Shelby, for this opportunity to share with you the views of our nation's community bankers. I would be happy to answer any questions you or other committee members may have.