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Before the Subcommittee on Financial Institutions,
Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C.
September 9, 2003

Thank you, Chairman Bennett, Ranking Member Johnson, and distinguished members of the Subcommittee on Financial Institutions. I appreciate the opportunity to speak with you today about the Federal Housing Finance Board (Finance Board) and the Federal Home Loan Bank System.

Many important issues are facing the nation's government sponsored enterprises (GSEs), including, certainly, the Federal Home Loan Banks (Banks). I highlight today the aggressive steps we have taken at the Federal Housing Finance Board, the System's regulator, first, to strengthen the agency's oversight capabilities; and second, to improve financial disclosures by the Federal Home Loan Banks through voluntary registration with the Securities and Exchange Commission (SEC).

These initiatives will benefit not just the Federal Home Loan Banks and their member institutions, but also the investors that purchase the Banks' debt, the taxpayers, and ultimately, the home-buying public who are served by the housing finance mission of the Banks.

As requested in Chairman Bennett's invitation to this oversight hearing, I will also address the issues of multidistrict memberships in Federal Home Loan Banks and the Banks' various Acquired Member Asset programs (AMA).

Allow me to begin by providing a brief overview of both the Federal Housing Finance Board and the entities we regulate, the 12 Federal Home Loan Banks and the Office of Finance.

The Federal Housing Finance Board is an independent agency in the executive branch of the U.S. government, with a five-member Board of Directors, four appointed by the President and one ex-officio member, the Secretary of Housing and Urban Development. Created to take over certain duties of the Federal Home Loan Bank Board by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Finance Board's primary duty is to ensure that the 12 Federal Home Loan Banks and the Office of Finance operate in a financially safe and sound manner.

In addition, the Finance Board ensures that the Federal Home Loan Banks carry out their housing finance and community lending mission and remain adequately capitalized and able to raise funds in the capital markets. The Federal Home Loan Bank Act requires the Finance Board to examine and report on the condition of each Federal

Home Loan Bank at least annually. Finally, the Finance Board is a non-appropriated agency that enacts its own budget; it assesses the Banks for the costs of its operation.

The 12 Federal Home Loan Banks and their joint office, the Office of Finance, serve the public by promoting the availability of housing finance, including community lending credit, through 8000-plus member institutions. The 12 Banks provide a readily available, low-cost source of funds to members and a secondary market facility for home mortgages originated or acquired by their members. The Banks are cooperatives; only members may own the stock of each Federal Home Loan Bank, and the members receive dividends on their investment. Insured banks, thrifts, and credit unions and insurance companies engaged in housing finance can apply for membership.

The Federal Home Loan Banks play a unique role in housing finance. They make loans, called advances, to their members and eligible housing associates (principally state housing finance agencies) on the security of mortgages and other collateral pledged by those members and housing associates. Advances generally support mortgage originations, provide term funding for portfolio lending, and may be used to provide funds to any member "community financial institution" (an FDIC-insured institution with assets of $538 million or less) for loans to small business, small farms, and small agribusiness. Because portfolio lenders may originate loans they are unwilling or unable to sell in the secondary mortgage market, Federal Home Loan Bank advances serve as a funding source for a variety of mortgages. This flexibility allows these advances to support important housing markets, including those focused on low- and moderate-income households.

Federal Home Loan Bank advances can provide funding to smaller lenders that lack diverse funding sources. Smaller community lenders often do not have access to funding alternatives available to larger financial entities, including repurchase agreements, commercial paper, and brokered deposits. The Federal Home Loan Banks give these lenders access to competitively priced wholesale funding.

The Federal Home Loan Banks principally fund themselves by issuing consolidated obligations, which are the primary obligation of a sponsoring Bank or Banks, backed by a joint-and-several liability guarantee of all Banks. Consolidated obligations outstanding at June 30, 2003, totaled $712.4 billion. This includes bonds (original maturity of one year or longer) of $556.2 billion and discount notes (original maturity of less than one year) of $156.2 billion.

Finally, a few more key figures: Total assets of the Federal Home Loan Banks stood at $812 billion as of June 30, 2003. Advances totaled $506.3 billion, which is 7.6 percent greater than one year ago. Viewed collectively, the Federal Home Loan Banks represent the third largest domestic banking organization.

Institutions of this size and importance to the nation's housing market and economy in general clearly require a robust and capable regulator, and since President

Bush named me Chairman in December 2001, I have sought to establish the Finance Board as just that.

## IMPROVEMENTS IN SAFETY AND SOUNDNESS OVERSIGHT

Soon after I became Chairman, my Finance Board colleagues and I determined that the Finance Board lacked the necessary resources to effectively carry out its primary responsibility, that of overseeing the Federal Home Loan Banks and the Office of Finance for safety and soundness. Just one example demonstrates this point: The Finance Board had only eight bank examiners on staff to review and supervise a dozen financial institutions with, at the time, more than $700 billion in assets, more than $30 billion in capital, and some $650 billion in outstanding debt. Yet the agency also had an Office of Public Affairs with the same number of staff, eight. The relative allocation of resources simply did not meet the agency's statutory mandates.

In addition to being understaffed, the examination function was also insufficiently focused on the Banks' risk assessment processes and the Banks' internal control systems. Such shortcomings had been identified in a 1998 General Accounting Office (GAO) report of the Finance Board's examination program, but had not by that time been addressed and corrected.

I immediately set out to respond to these problems, beginning with the recruitment of new leadership for the agency's Office of Supervision. After a national search, the Finance Board hired a new director and a new deputy director of supervision, who between them have 40 years of regulatory experience with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC).

My Finance Board colleagues and I increased the resources available for supervision, expanding the agency's examination staff to 17 full-time bank examiners. Our goal is to have 24 in place by the end of this calendar year, and 30 by the end of the next budget year.

The Finance Board is now conducting more thorough, risk-focused examinations, and communicating the results of those examinations more effectively to the Banks.

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

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

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

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

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

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

The 1998 GAO report also found that Finance Board examinations neglected the critical area of board governance at the Federal Home Loan Banks. To address this shortcoming, and as another element of our safety and soundness supervision, the Finance Board has undertaken a thorough assessment of corporate governance at each of the Banks. This effort included the first-ever horizontal review – that is, a systemwide supervisory review of a single issue at each of the 12 Banks – which addressed the Banks' effectiveness relative to eight indicators of effective board governance.

Those indicators are:

- Engaged Board of Directors
- Skilled Senior Management
- Thorough Strategic Planning
- Sound Risk Management
- Robust Internal Control
- Effective Audit Program
- Strong Ethical Culture
- Timely, Accurate, and Complete Communications

The Finance Board's final report on this review includes a variety of general recommendations for improving corporate governance. The agency also provided specific, confidential feedback to each of the 12 Banks.

The next step with respect to bank governance is a public hearing, tentatively scheduled for October 15. The Finance Board will solicit from the Banks, their member institutions, experts, and interested members of the public any ideas for reform in this important area. Input generated may be used in the design of proposals aimed at making the Federal Home Loan Banks role models in corporate governance.

Earlier this year, the Finance Board undertook a second systemwide horizontal review – that of the Federal Home Loan Banks' implementation of the statutorily mandated Affordable Housing Program (AHP). The AHP is a highly successful program that warrants a separate discussion and some background.

## THE AFFORDABLE HOUSING PROGRAM (AHP)

The Federal Home Loan Bank Act requires each Bank to establish and fund an Affordable Housing Program. Under the AHP, each Bank must annually contribute the greater of 10 percent of its net earnings for the previous year, or such prorated sums as may be required to ensure that the aggregate contribution of the Banks is at least $100 million. Actual contributions to the program were $199 million for 2002, and the contributions have exceeded $100 million each year since 1994.

AHP subsidies must be used to fund the purchase, construction, or rehabilitation of:

- Owner-occupied housing for very low-income, or low- or moderate-income (no greater than 80 percent of area median income) households; or
- Rental housing in which at least 20 percent of the units will be occupied by and affordable for very low-income (no greater than 50 percent of area median income) households.

In 2002, the Finance Board adopted a regulation enabling Banks to allocate annually the greater of $4.5 million or 35 percent of each Bank's AHP contribution to homeownership set-asides. Part of this increased funding authority helps Banks combine AHP subsidies with HUD initiatives benefiting minority, immigrant, and other first-time homebuyer families.

Since the inception of the AHP in 1990, the Federal Home Loan Banks have contributed $1.7 billion to the program, funding 236,596 rental units and 122,126 owner-occupied units. In 2002, the Banks committed $286 million to AHP projects.

The Finance Board appropriately devolved operation of the AHP program to the individual Banks in the late 1990s, a valuable development because the Banks are best equipped to assess local affordable housing needs and build partnerships with local community groups and housing agencies.

Correspondingly, the Finance Board's oversight responsibility has grown with respect to the AHP to ensure proper and effective program operation. As such, we are following up the horizontal review with a new practice of examining each Bank's AHP program once a year. These exams are performed by examiners and analysts whose specialized training has specifically equipped them for this task.

We are also preparing regulatory language intended to enhance the effectiveness of the AHP by permitting Banks more latitude in establishing the criteria to score applications. The goal is for Banks to be more responsive to local housing conditions. We also plan to streamline the application process to permit projects to proceed more quickly and with lower administrative costs.

AHP is truly one of the Federal Home Loan Banks' great success stories, and with rigorous oversight at the Federal Housing Finance Board, I am confident it will be even more successful in the years ahead.

## ENHANCED DISCLOSURES

The other key initiative I wish to discuss today is enhancing the quarterly and annual corporate disclosures of the Federal Home Loan Banks.

In July of 2002, the Administration called on all government sponsored enterprises to comply with the corporate disclosure requirements of the Securities Exchange Act of 1934, as interpreted and enforced by the SEC.

Fannie Mae and Freddie Mac, the other two housing-related GSEs, answered this call. Fannie Mae has already filed its first disclosures under the new SEC regime.

As Chairman of the Federal Housing Finance Board, I too am determined to hold the Federal Home Loan Banks to the highest standard of disclosure. Accordingly, I formed a working group from the Finance Board and the Federal Home Loan Banks to review the implications of acceding to the Administration's request.

Early this year, I concluded that voluntary registration with the SEC was indeed the best approach to providing enhanced public disclosure of the operations and finances of the Federal Home Loan Banks. I reached this conclusion based on two premises.

First, the Banks' long-term access to global capital markets will be enhanced by providing investors in consolidated obligations with maximum reliable transparency into the finances and governance of each of the 12 Banks. Markets function best, especially in times of stress, when needed information is readily available and reliable.

Second, as public trusts, these 12 GSEs have a duty to contribute both to the smooth functioning of capital and mortgage finance markets and to public confidence that the benefits of GSE status are used wisely.

At my urging, Federal Home Loan Banks and the staff of the SEC have held numerous meetings to address the process for voluntary registration, including methods for resolving several key disclosure and accounting questions.

The Board of Directors of the Federal Home Loan Bank of Cincinnati actively embraced the disclosure initiative as in the best interest of its members, voting in February to pursue voluntary registration. Last month, the Cincinnati board resolved to "actively engage, effective immediately, in the process of voluntary registration with the SEC of its member-held stock."

This summer, too, the boards of the Federal Home Loan Bank of San Francisco and the Federal Home Loan Bank of Atlanta resolved that if SEC registration was the determined course of action, it is their request that the Finance Board adopt a regulation requiring it.

In response to those requests, at its regularly scheduled meeting tomorrow the Finance Board will consider a proposed regulation requiring each Bank to register a class of securities with the SEC under section 12(g) of the Securities Exchange Act of 1934.

The proposed rule provides for a lengthy, 120-day comment period, during which, I hope, the Banks will each meet with the SEC to work out the necessary details to effectuate registration and begin meeting the periodic financial reporting requirements of the '34 Act.

The focus of the enhanced disclosure effort from the start has been to ensure that the Federal Home Loan Banks play their part, as government sponsored enterprises, in contributing to the smooth functioning of the capital and mortgage finance markets. In the end, consistent and full disclosures of these institutions' finances and corporate governance also serve the public, who stand behind their charters as government sponsored enterprises.

## ACQUIRED MEMBER ASSETS (AMA)

I have been asked to address two other issues in my testimony today. The first of these concerns regulations governing the Acquired Member Assets programs, or AMA, of the Federal Home Loan Banks.

The 12 Federal Home Loan Banks are authorized to purchase single-family mortgages that do not exceed the conforming loan limit applicable to Fannie Mae and Freddie Mac, currently $322,700. The authority granted under the current rule (12 C.F.R. Part 955) is an expansion and refinement of previous authority that had been granted to the Banks by a Finance Board resolution in 1996. That authority was challenged in 1997, a challenge rejected by a U. S. District Court in 1998. The U.S. Court of Appeals for the Fifth Circuit upheld the District Court's ruling in 2000, affirming the Finance Board's authority in this area.

There are currently two AMA programs – Mortgage Partnership Finance ™ (MPF) and Mortgage Purchase Program (MPP). MPF is the older and larger program. Under the current AMA programs, a Bank may purchase mortgage assets from a member institution. The programs, like advances, provide member institutions liquidity for mortgage lending. In AMA programs, the member manages and bears a material portion of the credit risk. Since the programs' inception in 1996, the Banks have purchased more than 600,000 loans. Approximately 75 percent of those loans were purchased under MPF and 25 percent under MPP. More than 95 percent of the total loan acquisition has occurred since 2000, the current AMA regulation having become effective on July 17, 2000.

On July 1 of this year, the Finance Board unanimously adopted and published for comment a proposed revision to the current AMA regulation. The Finance Board's intent is clearly stated in the preamble to the regulation, that is, to make the regulation more "effective and efficient in regulating the Banks' mortgage purchase programs." In the rule, the Finance Board also seeks to clarify and simplify the language of the current rule. The proposed regulation does not expand or alter the fundamental structure of the AMA programs.

The proposed regulatory changes also maintain or strengthen many appropriate safety and soundness provisions of the current rule, again reflecting the Finance Board's continued emphasis on improving its safety and soundness oversight of the Federal Home Loan Banks.

Safety and soundness provisions maintained or strengthened under the proposed rule include requirements that:

- All AMA must be at least investment grade when acquired by the Bank.
- The Bank must have in place a process and methodology to determine the required credit enhancement prior to acquisition of any asset and throughout the life of the asset on the Bank's books.
- The Bank must take remedial action by requiring the member to provide additional credit enhancement or hold additional capital if the estimated credit rating of the asset declines to below the rating required at time of acquisition.
- Insurers must be rated AA or better to provide a portion of the credit enhancement to the member institution selling assets to the Bank.
- Banks without risk-based capital structures in place must hold retained earnings for losses as support for the credit risk associated with any AMA estimated to be rated below AA.

In addition, the proposed regulation incorporates Finance Board criteria previously set forth in the preamble of the July 2000 final AMA rule outlining the circumstances under which Banks are permitted to acquire from members highly rated interests in pools of mortgages as an alternative to acquiring whole loans. Among the criteria is a requirement that all loans backing such interests must themselves be eligible for purchase by the Bank as AMA. As with any new AMA product, a Bank is only allowed to acquire such interests after its proposed program has been reviewed and approved under the Finance Board's New Business Activity regulation.

The proposal further seeks comment on whether the Finance Board should take measures to prevent a Bank from acquiring loans or assets backed by loans, through its AMA program, where the loans have features or were made under circumstances that may be considered predatory or abusive. The proposal also asks for comment on whether and how to limit Banks' authority to acquire such loans or assets backed by such loans.

The text of the proposed regulation maintains the current prohibition on purchases directly from affiliates of member institutions. In response to numerous requests from members using affiliates and subsidiaries for mortgage origination activities, the preamble does invite comment on changing current policy to allow affiliates owned and controlled by members to directly sell assets to Federal Home Loan Banks.

The importance of revising Finance Board regulations to better reflect the agency's supervision approach argues for a constructive exchange among the interested public, Federal Home Loan Banks, and the Finance Board. It appears, however, that some may have misunderstood the intention of this proposed regulation.

As a result, in agreement with my fellow Directors, I will ask the Finance Board to vote at its regular Board meeting tomorrow to withdraw the present rulemaking. The proposed text will be revised and clarified to more clearly enunciate the principles I listed above, and the resulting proposed regulation will be voted on in a subsequent meeting. If approved by the Finance Board, the revised proposed regulation will be published for a 90-day comment period.

## MULTIDISTRICT MEMBERSHIP

When I became Chairman of the Finance Board in December 2001, the multidistrict membership debate was already over a year old, having been prompted by regulatory requests filed in 2000 and 2001 by four Federal Home Loan Banks that had lost large members to mergers with institutions headquartered in other Federal Home Loan Bank districts. A Solicitation for Comments on the issue was pending and remained open until March 2002.

When Congress created the 12 Federal Home Loan Banks 71 years ago, it anticipated that each member thrift institution would operate where its collateral was located, and at that time, that meant in its home state alone. The financial world, of course, has fundamentally changed since 1932, as has the membership base of the

Federal Home Loan Banks now that membership is voluntary for all and open to commercial banks and credit unions, as well as thrifts and insurance companies.

With the advent of interstate banking and national holding companies, the Federal Home Loan Banks are operating in a different competitive environment than existed through most of their history. For Bank member institutions organized under certain holding company structures, multidistrict membership already exists. One hundred three holding companies, doing business in more than one Federal Home Loan Bank district through separately chartered subsidiaries, currently account for 451 distinct Bank memberships. Institutions that operate in multiple regions through a single charter, however, are precluded by Finance Board regulations from establishing similar operating arrangements with more than one Federal Home Loan Bank.

Let me make clear that, while it is my view that the Federal Home Loan Bank Act both empowers and obligates the Finance Board to continue regulating the terms of Bank membership to the extent necessary to ensure safe and sound operation of Banks, access by Banks to capital markets, and achievement of the Banks' housing finance mission, I am neither an advocate nor an opponent of expanding multidistrict membership in the Federal Home Loan Bank System.

When I became Chairman, I asked the four Banks seeking regulatory approval for multidistrict membership to withdraw their requests to permit a thorough, comprehensive review of the changed financial services industry and mortgage market circumstances that give rise to the multidistrict issue. That review has occurred without producing any compelling reason for the Finance Board to address the question of expanded multidistrict membership on its own initiative.

My commitment to those Banks that withdrew their pending regulatory requests, however, was that, when the review was complete, any Bank seeking authority to admit as a full member an institution doing business in that Bank's district but maintaining a charter and membership in another Federal Home Loan Bank district would be afforded an opportunity to make its case to the Finance Board and present its recommended solutions to the various operational challenges its proposal would raise. In June, in fulfillment of my commitment to those Banks, I requested the Office of Supervision and the Office of General Counsel to draft a proposed regulation establishing a process by which the Finance Board could receive, review, and accept or reject such applications, should any Bank choose to make one. No Bank, however, has made any request to the Finance Board to proceed on multidistrict membership, the draft proposal was never completed, and no further Finance Board action establishing a procedure is planned.

## CONCLUSION

Chairman Bennett, distinguished members of the subcommittee, I close by returning to the very reason the Federal Housing Finance Board exists: to ensure that

Federal Home Loan Banks operate in a financially safe and sound manner, carry out their housing-finance mission, and remain adequately capitalized and able to raise funds in the capital markets.

Since 2002, the Finance Board has dramatically improved its ability to perform these statutorily mandated responsibilities. The agency's supervision function is stronger, more thorough, and more effective. Taken in conjunction with the initiative to enhance the financial disclosures filed by the Federal Home Loan Banks, I believe the Finance Board is capably representing the interests of the public and taxpayers who stand behind the Federal Home Loan Banks and who benefit from the successful performance of the Federal Home Loan Banks' important role in housing finance.