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Good morning, Chairman Shelby, Ranking Member Sarbanes, and distinguished members of the committee.

I am honored to appear before you today, and I thank you for the opportunity to discuss the Federal Housing Finance Board, the Federal Home Loan Bank System (Bank System) and reform of the government sponsored enterprises (GSEs).

Nearly four years ago, this committee and the Senate confirmed my nomination to be president of Ginnie Mae. Earlier this year, this committee and the Senate honored me with confirmation to membership on the Federal Housing Finance Board (Finance Board), and President Bush entrusted me with its chairmanship. The opportunity to serve is a great privilege, and I assure you that as Chairman, I am committed to ensuring that the Banks operate in a financially safe and sound manner, and carry out their housing finance mission. In that spirit, I offer today my experience, past and present, as you seek to develop policy for the supervision of the nation's housing GSEs.

Before I offer comments on GSE reform, I would like to provide you, the members of this distinguished committee, with a brief update on the financial performance of the Federal Home Loan Banks and some of the major issues facing the Bank System, so that you will have a comprehensive view of the Bank System to consider during your deliberations on this important issue.

The Financial Performance and Condition of the Federal Home Loan Banks

As of December 31, 2004, the Federal Home Loan Banks hold combined assets of $934 billion. If the Banks were all part of the same holding company, it would be the fourth largest bank holding company in the country. The San Francisco Bank is the largest of the 12 Banks with assets of $185 billion. The four smallest Banks have between $44 and $49 billion in assets.

In the aggregate, the Banks earned $1.9 billion in 2004, which was up from the $1.7 billion they earned in 2003. However, relative profitability is at historically low levels. Profitability, as measured by the return on average assets, has trended downward over the last decade before stabilizing at 21 basis points in 2003 and 2004.

All 12 Banks have capital above the regulatory minimum of four percent of assets, and System-wide the Banks have $42 billion in capital, or 4.5 percent of assets. Capital stock accounts for $40 billion of regulatory capital. Retained earnings account for the other $2 billion.

Loans to member institutions (called "advances") represent the largest asset category for the System. Advances represent 62 percent of Federal Home Loan Bank assets. As of December 31, 2004, the Banks had $581 billion of advances outstanding to their 8,131 members. Membership has remained fairly constant for several years, but the percentage of borrowing members has increased to 70 percent.

In addition to advances, Banks also supply liquidity to their members by purchasing from them non-jumbo single-family loans under either the Mortgage Purchase Program ("MPP") or the Mortgage Partnership Finance program ("MPF"). The Banks have $114 billion in mortgages; the largest holder is the Federal Home Loan Bank of Chicago, which has mortgages of $47 billion. Mortgage growth was flat in 2004 at both the Chicago Bank and the aggregate of the other 11 Banks.

In their more than 70 years of operation, no Bank has ever incurred a credit loss on an advance to a member. Collateralized advances, highly rated investment securities, and credit enhancements on mortgage loans assure a very high credit quality. Through their own policies and through Finance Board regulations, each Bank must maintain its interest-rate risk within strict limits. The Finance Board dedicates more supervisory and examination resources to the measurement and monitoring of interest-rate risk than any other supervisory or examination area.

Supervisory Written Agreements

Last year, the Finance Board entered into two supervisory “written agreements” — one with the Federal Home Loan Bank of Seattle and the other with the Federal Home Loan Bank of Chicago.

The Finance Board’s written agreement with the Federal Home Loan Bank of Seattle, issued in December 2004, addresses shortcomings in the Bank's corporate governance, risk management, capital management and financial performance. For several years, the Seattle Bank had been seeking growth and profitability by building a portfolio of purchased mortgage loans, agency debt securities, and mortgage-backed securities to supplement earnings from its advance business. As so often happens during periods of rapid growth, the Seattle Bank paid less attention to sound risk management practices than it should have.

Under the written agreement, the Finance Board required the Seattle Bank to hire independent third parties to conduct reviews of board and management oversight and the Bank’s risk management processes. Those reviews are under way. In addition, the Finance Board required the Seattle Bank to provide it with an acceptable three-year business and capital management plan. The Seattle Bank has submitted its proposal, which is under review by our examination and supervision staff.

In considering its strategic alternatives, the Bank’s board of directors has decided to focus on the Bank’s traditional mission assets, called “advances.” The Bank is developing strategies, subject to Finance Board review, to improve the Bank’s long-term financial position by decreasing its exposure to interest-rate fluctuations. They include enhanced hedging of interest-rate risk and the development of an exit strategy for the Mortgage Purchase Program.

Previously, in June 2004, the Finance Board entered into a written agreement with the Federal Home Loan Bank of Chicago. That agreement addressed shortcomings in the Bank's governance, risk management, internal audit, capital management, accounting, and financial recordkeeping practices. In February, the Finance Board accepted the Chicago Bank’s three-year business and capital management plan. The agreement also called for the Bank to maintain a 5.1 percent capital ratio and to engage an independent third-party to review the Chicago Bank's management and board governance, as well as the Bank's risk management, accounting, internal audit, and financial recordkeeping practices. The Chicago Bank is developing strategies, subject to Finance Board approval, to address the findings from those third-party reviews.

At the Finance Board we are continuing to assess the performance and condition of these two Banks. We are monitoring their progress in addressing their deficiencies. And, I can assure you, that we will take whatever additional measures, if any, are needed to maintain the safety and soundness of each of the Federal Home Loan Banks and the System as a whole.

Enhanced Disclosures

In June 2004, the board of directors at the Finance Board voted to adopt a final regulation requiring the Banks to register with the Securities and Exchange Commission (SEC). The Banks are required to file registration statements by no later than June 30, 2005, and to have their registrations effective by no later than August 29, 2005.

Finance Board staff has been working with the Banks to ensure that registration is accomplished. Over the past year, the Finance Board issued three Advisory Bulletins to the Banks to help guide them through the registration process. To date, all twelve of the Banks have filed draft Form 10s with the SEC and have received comment letters from the SEC. Half have submitted a second Form 10 responding to SEC comments. While the Banks are working towards compliance with the Finance Board's regulation, much work needs to be done and an enhanced effort is required. We further believe that given the size and importance of the Home Loan Bank System and the amount of its debt held by the public, Congress should make SEC registration mandatory for all housing GSEs.

Public Interest Directors

I would like to turn now to the appointment of public interest directors. The Federal Home Loan Bank Act (Bank Act) requires the Finance Board to appoint public interest directors, or more appropriately "outside directors" to the boards of the Banks. These public interest directors provide valuable and objective oversight of the management of the Banks because they are free from the pressures of providing low-cost advances and paying higher dividends. While I believe that corporate governance is enhanced by public interest directors, the historic way of selecting public interest directors is no longer appropriate. Simply put, the regulator should not appoint the regulated.

Until Congress changes the law, the Finance Board is faced with meeting its statutory obligation to appoint public interest directors. Therefore, we are currently developing a process by which we can assess the individual needs of each Bank and select public interest directors who not only have the desire to serve for relatively low compensation and potentially increased liability, but who also possess the requisite qualifications, knowledge, and skills necessary to satisfy the needs of the Bank's board. It is our expectation and intent that the Banks, as government-sponsored enterprises, be leaders in corporate governance.

Regulatory Authority

As for oversight of the GSEs, Congress and the Administration are engaged in a worthy effort, for there can be little debate over the need to have the very best supervision and regulation. I concur with this effort, and I believe that in order to accomplish these objectives, the regulator must have the powers that are most critical to providing effective and thorough oversight. First of all, the regulator should be able fund itself through an assessment of the GSEs outside of the appropriations process. The regulator should also have the ability to set minimum capital levels—leverage and risk based; to approve new and review existing business activities; and to place a failed institution into receivership. Each of these powers is currently possessed by the Finance Board.

As to the structure of the regulator, a consensus has emerged in support of one regulator for all the housing GSEs that is managed by a single director. While as a general matter, such a regulator should have comparable powers over all the GSEs, the regulator must recognize the fundamental differences between Fannie Mae and Freddie Mac on the one hand, and the FHLBanks on the other. For example, Fannie Mae and Freddie Mac are publicly traded, shareholder-owned enterprises that have the pressures attendant to being a public company. They securitize mortgages on a nationwide basis. In contrast, the Federal Home Loan Banks are regionally based, member-owned cooperatives that provide low-cost financing to their member institutions. They are free from the pressures of publicly owned companies, and they do not securitize mortgages.

I commend this committee for acknowledging the differences between the GSEs in its reform legislation last year as well as this year's bill introduced by Senators Hagel, Dole and Sununu.

Affordable Housing Program

Lastly, the Federal Home Loan Bank Act requires each Bank to establish and fund an Affordable Housing Program (AHP). Under the AHP, each Bank must annually contribute 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.

By statute, 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.

On March 18, 2005, the Finance Board released a System-wide review of the Banks' Affordable Housing Program. We found that the AHP has contributed substantially to affordable housing since the program's creation in 1990. Since its inception, the Banks have awarded more than $2 billion in AHP grants. Between 1990 and 2004, nearly 430,000 housing units have been subsidized with AHP funds. In 2004, $229 million was made available by the Banks to subsidize 39,802 units of owner-occupied or rental housing.

While the System-wide review presented a lot of good news, there is room for improvement.

Clearly, AHP is a success story, and with continued rigorous oversight at the Finance Board or by a new regulatory agency, I am confident it will be even more successful in the years ahead.

Chairman Shelby, Ranking Member Sarbanes, and members of the committee, thank you for this opportunity. I would be pleased to answer your questions.