Statement of

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Good Afternoon Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee. My name is Lee Gibson and I am Chairman of the Council of Federal Home Loan Banks as well as Chairman of the Federal Home Loan Bank of Dallas. I am also the Chief Financial Officer and Senior Executive Vice President of Southside Bank, a $3 billion community bank with headquarters in Tyler, Texas that is a member of the Federal Home Loan Bank of Dallas. I appreciate the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks (Council), a trade association representing all twelve Federal Home Loan Banks (FHLBanks).

Federal Home Loan Bank System Overview

At the outset I would like to describe the FHLBanks and their critical role in providing cost-effective funding to members for use in housing finance and community and economic development.

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

During the nation's financial crisis, when dislocations in the capital markets made funding from other sources difficult, the FHLBanks were the first available source of funding for U.S. financial institutions, preventing far greater losses and potential institutional failures. The FHLBanks were able to increase their lending to members of every asset size and in every part of the country by more than $350 billion, from a total of $650 billion in the second quarter of 2007 to over $1 trillion in the third quarter of 2008. The FHLBank System is built to be scalable - advance levels ebb and flow with credit cycles to match member demand. Since the height of the crisis, advances have declined by more than half as weak asset growth and excess liquidity have stemmed members' demand for credit. The decline in advance levels, following their rapid expansion, is further evidence that the FHLBank model works as intended.

The FHLBank System has a unique cooperative structure, comprised of twelve regional FHLBanks, their 7,795 member financial institutions, and the Office of Finance that issues debt on behalf of the twelve regional FHLBanks. The FHLBanks are overseen by an independent regulator, the Federal Housing Finance Agency (FHFA), established by the Housing and

Economic Recovery Act of 2008 (HERA Act of 2008). Each FHLBank is a separate and distinct corporate entity with its own stockholder / member institutions and its own board of directors. While the FHLBanks issue debt collectively and are jointly and severally liable for the repayment of those debt obligations, there is no single controlling corporate entity with responsibility for, or authority over, the FHLBanks. The twelve FHLBanks operate independently under the authority granted by Congress through the Federal Home Loan Bank Act, as amended, and in accordance with the regulations established by the FHFA.

The FHLBanks are cooperative institutions that operate within districts originally established by the Federal Home Loan Bank Board, one of the predecessors to the FHFA. Each FHLBank's capital stock is owned only by its member institutions. Each member must purchase the FHLBank's capital stock in order to become a member, and must maintain capital stock holdings sufficient to support its business activity with the FHLBank in accordance with the individual FHLBank's capital plan.

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

As cooperatives, FHLBanks are not subject to the growth imperative that often drives the decisions of publicly-traded corporations. Demand for advances expands and contracts with economic and market conditions and the FHLBanks' capital structure supports this movement. Membership requires a baseline capital contribution based on the amount of assets on the member's balance sheet. In addition, each time a member takes out an advance, it must purchase additional "activity-based" capital in proportion to the face value of that advance.

During periods of credit expansion, the cooperative structure provides additional capital to support advances growth. During periods of extreme distress, such as the recent liquidity crisis, the System's capital structure ensures adequate capitalization: as member liquidity needs increase demand for advances, the self-capitalizing nature of these borrowings enables the FHLBanks to extend credit while preserving the safety and soundness of each cooperative.

Equally important to the scalability of the System is the scalability of its infrastructure, which has expanded in recent years due to changing requirements in risk management and internal control. The wholesale nature of the business enables the System to function with a small number of staff relative to its asset size. Together with the Office of Finance, the FHLBanks' debt issuance agent, the FHLBanks employ about 3,000 persons to manage $809 billion in assets as of Q2 2011. Significant investments in information technology have made this scale possible. Across the FHLBanks, the people, processes, and systems in place can handle varying degrees of business without incurring significant additional costs.

Having recently completed their statutory obligation under the Federal Home Loan Bank Act to make payments related to the Resolution Funding Corporation, the FHLBanks have undertaken a joint capital enhancement agreement to further strengthen their financial soundness. Each FHLBank will now, on a quarterly basis, allocate 20 percent of its net income to a separate restricted retained earnings account established by that FHLBank. Under the agreement, each FHLBank will build its separate restricted retained earnings account to an amount equal to one percent of its total outstanding consolidated obligations.

Corporate Governance of the FHLBanks: The Role of the Board of Directors

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

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

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

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

FHFA regulations require that the FHLBanks' boards of directors not only fulfill the typical corporate director duties of care and loyalty, but that they also carry out specific responsibilities. These duties include, but are not limited to, the responsibility to select and oversee management, the responsibility to ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, and a member products policy that details the Bank's credit and pricing policies, and the responsibility to approve the FHLBank's annual operating budget and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. FHFA regulations require each FHLBank's board of directors to have an audit committee with very specific regulatory responsibilities, including direct oversight of the FHLBank's internal and external audit functions. The boards of directors also typically establish other committees to facilitate their oversight of management. Committees vary from FHLBank to FHLBank, but typically include risk management, human resources and housing program oversight functions. The various elements of the FHLBanks' corporate governance structure combine to provide boards of directors that are active, knowledgeable, and engaged, and that are fully aware of their responsibilities and take them seriously.

FHLBank Advances and Member Services

In accordance with statutory requirements, all advances are secured by eligible collateral and the purchase of capital stock. When FHLBanks issue advances, they lend against both the credit of the member-borrower and the quality of the collateral. Each FHLBank establishes its own processes and procedures for assessing these characteristics based on its understanding of the markets. Credit monitoring, for example, considers microeconomic trends and local laws and regulations. This is accomplished through data collection, financial analysis, and substantive interaction with members' management teams.

Each FHLBank's collateral team establishes the lendable value of a members' assets through site reviews, loan level pricing, and future exposure discounting. Review teams need to understand and consider regional variations in order to assess the risk profile and value of collateral. For example, some markets are dominated by larger commercial banks where others are primarily served by community financial institutions. Some markets display a concentration of loans exceeding the conforming loan limits, where others are well within the limits. On the coasts, there is a higher concentration of commercial real estate lending, and in the midwest some institutions specialize in agricultural lending.

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

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

FHLBank Mortgage Purchase Programs

The System has an excellent track record of working with members to manage risk in the mortgage purchase programs that some FHLBanks have administered for the last decade. In these programs, a participating FHLBank purchases traditional prime single-family mortgages originated by member institutions under a risk-sharing agreement between the FHLBank and the member. The collective portfolio of mortgage loans carries a 4.16% delinquency rate in comparison to a 7.05% delinquency rate for all prime loans nationwide. Total actual credit losses from mortgage investments since the program's inception in 1997 have been approximately 3 basis points of total mortgages funded.

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

FHLBank Housing and Community Lending Programs

For more than 20 years, the FHLBanks' Affordable Housing Program (AHP) has been one of the largest private sources of grant funds for affordable housing in the United States. It is funded with 10% of the FHLBanks' net income each year. These grant funds are distributed through a competitive process to projects developed through partnerships of member institutions and local developers and housing organizations. AHP grants subsidize the cost of owner-occupied housing for individuals and families with incomes at or below 80 percent of the area median income (AMI), and rental housing in which at least 20 percent of the units are reserved for households with incomes at or below 50 percent of AMI. The subsidy may be in the form of a grant or a below- cost or subsidized interest rate on an advance. AHP funds are primarily available through a competitive application program at each of the FHLBanks. AHP funds are also awarded through a homeownership set-aside program to assist low and moderate income households in purchasing homes, with at least one-third of the funds being used to assist first-time homebuyers. The AHP allows for and encourages funds to be used in combination with other programs and funding sources, such as the Low-Income Housing Tax Credit. These projects serve a wide range of neighborhood needs: many are designed for seniors, the disabled, homeless families, first-time homeowners and others with limited resources. As of year- end 2010, more than 742,000 housing units have been built using AHP funds, including 457,000 units for very low-income residents. The total AHP dollars awarded from 1990 through 2010 is approximately $4.3 billion.

Each Federal Home Loan Bank also operates a Community Investment Program (CIP) that offers below-market-rate loans to members for long-term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods. Members use CIP advances to fund the purchase, construction, rehabilitation, refinancing, or predevelopment financing of owner-occupied and rental housing for households with incomes at or below 115 percent of AMI. The program is designed to be a catalyst for economic development since it supports projects that create and preserve jobs and help build infrastructure to support growth. Lenders have used CIP to fund owner-occupied and rental housing, and to construct roads, bridges, and sewage treatment plants as well as to provide small business loans. From 1990 to 2010, the FHLBanks' CIPs have lent over $61 billion for a variety of projects, resulting in 726,000 housing units.

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

Risk Management of the FHLBanks

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

In large part due to the incentives created by the FHLBanks' cooperative structure, risk aversion and conservative risk management practices are ingrained in the corporate culture. This same conservative approach to risk management is also reflected in both the legal restrictions and the FHFA's regulatory regime. For instance, the Federal Home Loan Bank Act and the FHFA's implementing regulations clearly describe and mandate the various limitations on the types of collateral the FHLBanks may accept to secure advances. Regulations limit the types, amounts and required credit ratings on both short and long term investments the FHLBanks make with surplus funds.

In addition, FHFA regulations require that each FHLBank maintain a Risk Management Policy, reviewed at least annually and re-adopted at least every three years by its board of directors, which identifies specific risk management practices and limits for the individual FHLBank. These practices and limits are monitored by the FHLBanks' internal audit departments, which report their findings directly to the FHLBanks' boards of directors. The FHFA also monitors FHLBank compliance with these and other regulatory requirements through monthly call reports, constant off-site monitoring, and annual on-site examinations.

The FHLBanks are also subject to very conservative capital requirements imposed by statute in the Gramm-Leach-Bliley Act (GLB Act) and by FHFA regulations implementing those statutory requirements. These requirements specify that FHLBanks must have total capital equal to at least 4.0 percent of their total assets, and must have sufficient permanent capital (as defined by the GLB Act) to meet a risk-based capital regime established by FHFA regulation.

The FHLBanks minimize credit risk by ensuring that advances are fully secured, that their investments are limited to issuers or securities that are highly rated at the time the investments are made, and that their mortgage purchase programs have appropriate risk-sharing features. No FHLBank has ever suffered a credit loss on an advance to a member in the FHLBanks' history.

FHLBank Debt Issuance: Dependable Access to a Deep, Liquid Market for FHLBank Debt

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

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

Another benefit of the depth and liquidity of the market for FHLBank debt is that the System is able to rapidly scale up its issuance with member demand for advances. The FHLBank debt franchise is well-recognized and highly-desired by a host of global investors due to its liquidity and credit quality. During 2007 and 2008, against a dislocated bond market, the System was able to increase debt outstanding by $360 billion over 15 months. This added funding provided a lifeline to members across the country and undoubtedly stemmed the flow of failures. It is because of the depth and liquidity of the FHLBank debt market that the System is able to tap the markets in size when demand surges—even during extreme distress.

Issues Facing the FHLBank System

A. Any Changes to FHLBank Membership Should Be Initiated By Congress

Last year the Federal Housing Finance Agency (FHFA) published for public comment an advance notice of proposed rulemaking (ANPR) to review current FHLBank membership requirements.

In response to the ANPR the FHFA received 137 comments, the vast majority of which expressed opposition to the suggested membership changes. Among those submitting comments raising concerns over these changes - in addition to the Council and the twelve FHLBanks - were the American Bankers Association (ABA), the Independent Community Bankers of America (ICBA), the National Association of Homebuilders (NAHB), the American Council of Life Insurers (ACLI), the National Association of Mutual Insurance Companies (NAMIC), the National Association of Federal Credit Unions (NAFCU), the Credit Union National Association (CUNA), the Mortgage Bankers Association (MBA), and a joint comment including the Financial Services Roundtable (FSR), the American Insurance Association (AIA), and the Property Casualty Insurers Association of America (PCIAA). In addition, comment letters on the ANPR were submitted by House Financial Services Chairman Spencer Bachus as well as Ranking Member Barney Frank.

Any changes to the FHLBanks' membership or mission – especially changes that would restrict membership eligibility or narrow the FHLBanks' mission - should come first from Congress. The FHFA should not proceed down a path toward fundamentally altering the FHLBank System without express Congressional guidance, especially at this time when Congress and the Administration are undertaking a top to bottom review of the housing finance system in the United States, including a review of the important role served by the FHLBanks as a provider of liquidity.

The regulatory changes being considered would make it more difficult for financial institutions to access the liquidity available through FHLBank advances and would devalue membership for existing FHLBank members and discourage potential members from joining, ultimately inhibiting the ability of FHLBanks to serve the housing and community development needs of their districts. These potential changes would be especially burdensome to small and medium sized members, at a time when these members are already subject to many other new regulatory requirements.

At a time when policymakers should be looking for ways to jump start economic activity by encouraging banks and other financial institutions to increase their lending to small businesses and other job creating activities, the changes being considered threaten to limit access to the low-cost funding provided by the FHLBanks. It is an example of the mixed messages being sent to community banks from some in Washington. Such mixed messages continue to create uncertainty and impede the economic recovery.

B. Borrowing Limits Should Not be Imposed on Members of the FHLBank System

The Administration's February 2011 report to Congress on reforming the housing finance system included, as a potential reform for the FHLBanks, limiting the level of advances for large financial institutions. Limiting the borrowing activity of large members would impair the ability of the FHLBanks to fulfill their mission of supporting housing and economic development in communities throughout their districts and could have the unintended consequences of higher costs of funds for smaller banks and for end consumers.

Large member borrowing is mission-consistent and beneficial to smaller members. The participation of large institutions in the FHLBanks strengthens the industry as a whole and enhances the value that individual FHLBanks deliver to members of all sizes; especially smaller members.

The composition of the FHLBank membership closely approximates the composition of the banking industry. As a result of membership requirements and the nature of collateralized borrowing, large institutions actually participate in housing finance to a greater extent than they participate in the FHLBank System. FHLBank participation of large members reflects their role in housing finance. At year-end 2010 the FHLBanks extended $177 billion in advances to their ten largest members, representing 38% of total advances. Collectively, these members hold over $2.5 trillion in mortgage assets and accounted for 68% of all residential mortgage originations in 2010. Against this outsized role and substantial supply of mortgage collateral, the participation of large members is both reasonable and mission-consistent.

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

Institutions of all sizes—from the $2 million credit union to the $1 trillion-dollar bank—benefit from equal access to liquidity through the FHLBanks.

Participation of all members strengthens the System. Not only does the housing finance market benefit from large members' access to the FHLBanks, small- and medium-sized members benefit from the participation of larger institutions in the System in three crucial ways:

- First, advances to large institutions bring with them commensurate amounts of invested capital across which to spread the impact of operating expenses on returns, which in turn allows the FHLBanks to operate on narrower interest margins and reduces the cost of credit to all members. This effect supports the costs of maintaining the risk management, internal control, and other compliance infrastructure that are critical to ensuring that the FHLBanks operate in a manner consistent with their responsibilities as GSEs.

- Second, larger volumes of advances increase the FHLBanks' income, which helps to build retained earnings cushions. In both regards, large member participation strengthens the economics of the cooperative.

- Third, advances to large members facilitate a critical mass of debt issuance which contributes to the FHLBanks' market presence. A deep, liquid market for FHLBank debt is critical to the success of the System because it enables FHLBanks to extend credit at a reasonable cost and rapidly grow or shrink with member demand. While it is impossible to quantify the market liquidity benefit, any incremental pricing discount attributable to the depth of the market is especially meaningful to small- and medium-sized institutions, which have less outside access to the capital markets.

Further, the depth of the FHLBank debt markets provides sufficient liquidity to serve all members, ensuring that smaller borrowers never get crowded out by larger ones. On the funding side, the robust market for agency debt pre-empts the need to ration credit and allows the FHLBanks to translate this increased demand into a pricing and liquidity advantage for small- and medium-sized members.

Layers of protection mitigate any incremental risks that may be posed by large borrowers. Advances are by regulatory requirement overcollateralized. Through a rigorous process, each FHLBank continually manages the pool of collateral backing an advance. This includes frequent monitoring of performance, pricing, and valuation. Members are required to maintain a sufficient pool of performing collateral, so they regularly replace delinquent loans and add collateral based on changes in haircuts and valuation. These precautions ensure sufficient overcollateralization at all times.

When an FHLBank lends to a troubled member, it does so in consultation with that member's primary regulator. In the event that the member subsequently becomes insolvent, this process enables the FDIC to minimize losses to the Deposit Insurance Fund. In a liquidation scenario, the

FDIC typically pays off outstanding advances in exchange for the timely release of collateral in an attempt to maximize the resolution value of the institution. Should the FDIC opt out of this arrangement, the FHLBank can liquidate the collateral to pay off any advances.

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

From the vantage point of debt investors and taxpayers, the FHLBanks' joint and several liability structure provides additional insulation from any loss that might occur at an individual FHLBank. Even if an FHLBank suffers losses, the aggregate amount of capital stock and retained earnings on the balance sheet of the FHLBanks, collectively, would provide a deep layer of insulation from losses. The combination of the FHLBanks' cooperative structure and the multiple layers of risk mitigation provide an abundance of private capital to buffer bondholders and taxpayers from potential losses.

FHLBank governance structure guards against concentration of influence by large members. The governance and composition of FHLBank boards are engineered to prevent any single member from exerting undue influence over an FHLBank's pricing, policies, or risk management. First, 40% of all directors are independent (i.e., not affiliated with a member institution). Second, the rules for election of member directors limit the number of votes that large members can cast, effectively ensuring that smaller members are well-represented. As a result, 63% of all member directors represent institutions with less than $1 billion in assets.

While it may seem counterintuitive, the participation of large banks is a precondition for a level playing field for smaller institutions. Inhibiting large members' borrowing activity would reduce scale efficiencies across the FHLBanks, thereby increasing borrowing costs for all members and ultimately for consumers. It also may impair the FHLBanks' ability to tap the debt markets in a crisis and limit their ability to support the industry during systemic crises. Having debt that is marketable to a broad cross-section of investors is key to this ability to rapidly scale up. A consistently smaller market for FHLBank debt may cause some investors to look elsewhere for investments, decreasing the number of regular participants in the market.

Debt investors value the liquidity of agency issues almost as much as they value their credit quality. The resulting decline in the issuance scale by the FHLBank System from the absence of large member participation would negatively impact the liquidity and appeal of remaining System debt issuances. This could result in increasing the cost of FHLBank funding during a financial market crisis, the cost of advances funding to members, and, by extension, the cost of mortgage lending to home buyers and owners.

C. Limiting Holding Companies to One FHLBank Membership Would Concentrate Risk and Weaken Some Members' Ties to Affordable Housing and Their Local Communities

The Administration's February 2011 report to Congress on reforming the housing finance system also included as a potential reform for the FHLBanks the concept of allowing each financial institution to be an active member in only a single FHLBank. This proposal would impair the ability of the FHLBanks to fulfill their mission to support housing and economic development in communities throughout their districts and would have unintended consequences that are counter-productive.

Currently, FHLBank membership is tied to charters: one FHLBank membership per charter. A bank holding company— though it cannot join directly— may maintain an active FHLBank membership for each chartered entity that it operates.

The current format provides two substantial benefits to the strength of the System. First, it spreads out advances business. Fostering a diversification of advances income is integral to the regional structure of the System. Forcing larger members to choose a single FHLBank could adversely affect the System by concentrating business in a few districts. Second, aligning FHLBank membership by charter effectively diversifies risk by enabling different discrete FHLBank management teams to each handle a share of the business. This diversification promotes safety and soundness, as multiple management teams are unlikely to pursue and implement the same strategies.

The transition to single FHLBank membership would provide the opportunity for members to play FHLBanks against one another in order to secure advantages or concessions. Negotiating power would be especially strong for larger members, whose larger capital investments and advances usage can provide scalability to a cooperative. Today, this situation is mitigated by the fact that membership is neither permanent nor limited. Arbitrarily creating a deadline would erase this mitigating factor.

All in all, this policy shift would undermine the stability of the System, creating incentives that run contrary to prudent risk management.

Some holding companies choose to maintain separate charters for their subsidiaries in order to create closer ties with that institution's community and to maintain a local presence. One way that these institutions do so is through the Affordable Housing Program (AHP) of their regional FHLBank. Limiting a holding company to a single FHLBank membership would effectively limit some members' participation in AHP in their district. This would have the effect of concentrating AHP funds in some districts at the expense of others, arbitrarily punishing some members and communities while rewarding others. In addition, this action would place additional strain on each FHLBanks' affordable housing staff and resources as they are faced with managing and monitoring a growing number of out of district affordable housing projects. If this became the case, it would divert AHP funds away from the district in which they were generated and outside of the regional expertise of a particular FHLBank.

The rules that govern membership in the System have evolved over time with the mortgage markets. In their present form, these rules ensure that the FHLBanks can both help lenders to finance housing and community development and support the industry in times of crisis. Proposed changes to membership rules could weaken the mission, carrying unintended consequences. In the case of consolidating memberships at the parent level, the consequences could be less robust risk management and less productive AHP relationships.

The FHLBank System is anchored in the strength and diversity of its membership. Any changes to membership rules should preserve the reciprocal relationship between each member, each cooperative, and the System as a whole.

D. Proposed Changes in Investment Authority May Also Undermine the System's Ability to Carry Out its Mission

The Administration's February 2011 report to Congress on reforming the housing finance system included, as a potential reform for the FHLBanks, the concept of reducing and altering the composition of the FHLBanks' investment portfolios to better serve the FHLBanks' mission of providing liquidity and access to capital for insured depository institutions. These suggested reforms are unnecessary for the following reasons.

FHLBanks hold two different types of investment portfolios. The first consists of short-term liquidity investments in Fed Funds Sold and highly-rated money market instruments. The primary purpose of these investments is to provide a significant pool of liquidity to support advances demand.

The second portfolio of investments consists of longer term U.S. Government- and Agency-supported investments, mortgage-backed securities and housing finance agency bonds. These mortgage related investments are consistent with the mission of the System because they support housing finance across the nation. They can also provide pools of liquidity to support advances demand in the event that the debt markets become dislocated. During a FHLBank-specific crisis, high-quality investments could be liquefied through repurchase agreements.

Investment portfolios are central to the scalability of each cooperative. Demand for advances changes cyclically, but the fixed costs of doing business have continued to rise year after year. The primary driver behind these increases is the cost of strengthening risk management, internal control, and compliance processes, which have far outpaced inflation in recent years. Assessments paid to support the operations of the FHFA have also increased rapidly, rising 77 percent from 2006 to 2010, and 175 percent since 2001. In periods such as this one, in which demand for advances is low due to high levels of liquidity in the industry, investment portfolios bridge the gap and maintain a sufficient baseline amount of income to help cover costs and provide a reasonable return on capital.

Holdings of mortgage-backed securities are limited by the FHFA to three times capital. This limited investment universe includes securities issued by Ginnie Mae, Fannie Mae, Freddie Mac, and certain senior, credit-enhanced tranches of private securitizations. The leverage restriction effectively limits credit risk exposure and ensures that mortgage backed securities (MBS) investments do not dominate any FHLBank's balance sheet or crowd out advances lending.

As discussed, the cooperative structure of the FHLBanks does not incent excessive risk-taking. Because the par value of capital stock is fixed, and because the FHLBanks cannot offer management or directors any form of equity-based compensation, there is no pressure to deliver equity appreciation and thus less of an incentive to continually grow returns. FHLBanks have tried to invest prudently, without abusing their government sponsored enterprise (GSE) status, while providing a reasonable return on capital.

In the lead up to the crisis, the System overall maintained a buffer between its consolidated portfolio of MBS and its investable limit. Even after the regulator temporarily granted some FHLBanks the authority to invest up to six times capital in mortgage-backed securities, the System overall used its authority responsibly and stayed under the three times capital limit.

E. Basel III Liquidity

In December of last year, the Basel Committee on Bank Supervision issued a new international framework for liquidity risk measurement, standards and monitoring. This framework will be implemented in the United States through a joint rulemaking process conducted by all of the relevant banking agencies. According to research conducted by McKinsey & Co. for The Clearing House, unless modified during the rulemaking process, the Basel LCR liquidity framework, as currently calibrated, will result in a liquidity shortfall for the U.S. banking industry in excess of $1 trillion.

Financial institutions subject to the new Basel liquidity framework will be required to meet new liquidity tests. One of these tests is called the "liquidity coverage ratio" or "LCR," and a rulemaking to implement this standard is expected in the near future. The purpose of the LCR is to ensure that financial institutions hold enough liquid assets to survive a 30 day liquidity crisis. The FHLBanks agree that sufficient liquidity is necessary for the safe and sound operation of financial institutions and support the goal of the LCR. However, we also believe that some of the underlying assumptions that are used in applying the liquidity coverage ratio put U.S. firms at a competitive disadvantage. Further, they do not adequately consider the role and history of the FHLBanks as a source of liquidity.

One of the key functions of the FHLBank System is to provide a reliable source of liquidity for banks, savings associations, credit unions, community development financial institutions and insurance companies that provide housing finance and community lending for American consumers.

The System has successfully performed this function since it was established by Congress in 1932. The importance of the System in providing liquidity, even during the most adverse economic circumstances, was clearly demonstrated during the recent fiscal crisis. The FHLBanks dramatically increased their lending to member institutions in every part of the country between the second quarter of 2007 and the third quarter of 2008 (from $650 billion to $1 trillion).

However, as currently calibrated the Basel liquidity framework does not take into account the unused FHLBank advance capacity. Further, the framework would require a substantial haircut in crediting FHLBank consolidated obligations for liquidity purposes.

FHLBank consolidated obligations are highly liquid, and the market for these assets is extremely deep. Every day, on average, approximately $21.6 billion in consolidated obligations are issued by the FHLBanks.

The projected $1 trillion liquidity shortfall could be substantially reduced if unused FHLBank advance capacity were included in the liquid assert buffer. Allowing excess FHLBank capacity would reduce the shortfall by $250-400 billion. In addition, adjustments in the treatment of agency debt, including FHLBank obligations, would decrease the industry - wide liquid asset buffer shortfall by more than $450 billion. This would enable our financial institutions to devote more resources to the credit needs of our economy, rather than holding cash and Treasury instruments as a drag on their balance sheets.

Although the Basel framework does not specifically address the FHLBank System, which is unique to the United States; the Basel framework does afford each country flexibility in implementing the agreement to take into account specific national variances. Our regulators should use this rulemaking authority to ensure that that the Basel III implementation process does not impose discriminatory burdens on depository institution use of the FHLBank System and disadvantage American consumers.

Conclusion

Over their long history, the FHLBanks have played a critical role in supporting their member financial institutions' ability to meet the housing finance and credit needs of their local communities in all economic cycles and in all parts of the United States. The FHLBank cooperative model performed exceptionally well throughout one of the worst financial crisis in this nation's history, without requiring any taxpayer assistance. The FHLBanks remain economically strong today and continue to serve a vital function for their financial institution members and the communities they serve.

Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the FHLBanks. I would be happy to answer any questions you have.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Lee R. Gibson	Council of FHLBanks Federal Home Loan Bank of Dallas Southside Bank
3. Business Address and telephone number: [redacted]	
4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? ☐ Yes ☒ No	5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? ☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.