STATEMENT OF BRUCE A. MORRISON

CHAIRMAN
MORRISON PUBLIC AFFAIRS GROUP

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Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee, thank you for the opportunity to participate in this important hearing. The Federal Home Loan Banks were the nation's first housing GSE, created in the Hoover Administration in 1932. Appreciating the strengths that have kept the Banks relevant for almost 80 years, and understanding their weaknesses, are both important for formulating policies for their future in the context of GSE reform.

I have been deeply engaged in issues of housing finance since the 1970s when I worked as a legal services attorney specializing in housing matters. This work continued in the 1980s as a member of this Committee and in the 1990s as Chairman of the Federal Housing Finance Board, then regulator of the Federal Home Loan Banks. Since 2001, I have advised several financial institutions involved in housing finance.

Other witnesses are providing the Committee with extensive summaries of the history and operations of the Federal Home Loan Banks. I will not seek to duplicate that contribution. Rather, I will highlight what I see as the policy challenges presented by the current role of the Banks in the financial system and the choices that may arise for their future role as the Congress and Administration formulate reforms responding to the conservatorship of Fannie Mae and Freddie Mac.

From my perspective, oversight of the Federal Home Loan Banks falls into three categories: purpose, performance, and future prospects. While all three are inextricably related, each subject raises its own questions that are better answered when understood from these three perspectives.

Purpose

Liquidity. This one word describes the grease that lubricates the financial system. It is a trait that we take for granted until it is absent, such as in the money markets when Lehman failed. The Federal Home Loan Banks were created originally to provide liquidity to savings and loans and savings banks, and later to other financial institutions, including credit unions and commercial banks, to allow them to make and hold long term, fixed rate residential mortgages when their primary funding was shorter term deposits. This was done by allowing them to pledge such assets in exchange for "advances"—over-collateralized loans to members—that would replace or supplement deposits. Permitting members to

hold relatively illiquid mortgage assets in portfolio remains the central purpose of the Banks. The questions are liquidity for whom—what kinds of institutions—and for what—which types of assets.

Here are some observations on those questions:

Cooperative Ownership. The Federal Home Loan Banks are 12 cooperatives in which the power, subject to statute and federal regulation, rests with the members. If there are going to be GSEs, this is the best way to capitalize them. It removes the conflict inherent in having third party shareholders with no interest in the purpose of the enterprise except for its profitability. That inevitably leads to a distortion of focus and a diversion of the funding subsidy from public purpose to private gain, while keeping the risk with the taxpayers in the end. In a cooperative, the risk to taxpayers remains an issue to be addressed in the financial soundness and regulation of the enterprise, but the lender cooperative model insures that the benefits of GSE cost-of-funds pass through to the consumer. The members are joined together in the cooperative ownership, but in the marketplace they are competitors. This competition for customers tends to force the lower cost-of-funds to show up in lower rates on loans to borrowers.

Roles of Collateral. Collateral plays two roles for the Banks. First, it secures them against loss. Both the over-collateralization policy and the statutory "super lien" have prevented any credit losses on advances throughout the Banks' history, despite the failure of very large member-borrowers (e.g. WAMU). But collateral has also provided a way to define the "purpose" of advances. Misguided proposals to "track advances" have been deflected by explaining that when an asset is pledged as collateral for an advance, it is effectively funded by that advance. But these two roles for collateral are not without conflict. For purposes of mitigating risk, more collateral is always better, and the credit quality of the collateral, not its purpose, is of primary concern. However, if collateral is to be used to define the purpose of advances, targeting on "mission related assets" is the goal. This effectively bifurcates the collateral analysis into "what kinds of collateral must you pledge to get an advance?" and "what is the total amount of collateral available to secure an advance?"

Advances for Housing or Something More. The reason for the arcane discussion of collateral is to support a discussion of the purpose of advances. Are they for housing assets specifically, other types of assets particularly, such as agricultural or economic development loans, or for more general liquidity purposes for particular types of institutions or for all lenders. The current structure comes close to providing general liquidity lending to most institutions. The "housing lender" membership test is easily met and most quality assets will serve as collateral. Large members in particular have the flexibility to use the Banks as a lower-cost liquidity alternative to other capital market sources.

Size of Members. The Federal Home Loan Banks are a convenient source of funding for members of all sizes. They are a critical resource for community banks and some credit unions. But while the Banks tout their role in community banking, their balance sheets reveal that most of their advances go to large institutions. This situation reflects the distribution of assets in the banking system—an 80-20 rule in which 80% or more of the assets are held by 20% or fewer of the institutions. But it has long given rise to a variety of proposed changes, ranging from a limit on the size of institutions that can be members, to limits on holding companies with multiple Bank memberships through subsidiary institutions, to limits on the size of advances. These proposals are not driven by safety and soundness concerns, since even large failures have been absorbed without loss by the Banks. The question is one of purpose—to whom should the benefit of GSE cost-of-funds (implicitly or explicitly subsidized capital markets borrowing)

be extended. The membership of large institutions creates scale in the System, which both improves the prices on debt through expanded liquidity and funds the existence of 12 regional Bank. All members benefit from this arrangement. But should this extra government support be added to the benefits of large members—giving them yet another tool to fuel growth—or should it be reserved for community banks, albeit at a somewhat higher cost. This is a choice for Congress to make and I suggest one way to "square the circle" below in my section on the future.

Consolidation. Why 12 Banks? History is the answer. The system was designed with a view to replicating for savings institutions the central banking role of the Federal Reserve System for commercial banks. Neither system would be likely to have so many regional units if they were being created today. The current regional structure provides some diversity of practices and management and greater participation in management to a wider range of members. Joint and several liability for the debt issued for each of the Banks introduces some moral hazard in theory, but has actually imposed both regulatory and interbank constraints on risky behavior. And after the fate of Fannie and Freddie, the concept of one national Federal Home Loan Bank does not have quite the same appeal it may once have had. On the other hand, the current statutes are probably less flexible than they might be for voluntary combinations. In my view the benefits and burdens of the current structure are shared by the current members who are the owners of the individual Banks. Reorganization should be their choice, subject to regulatory oversight that protects against unsafe or unsound arrangements that would threaten individual Banks or the System overall.

Affordable Housing and Community Investment. The Affordable Housing Program (AHP) has been a huge success for the Banks. It is worth remembering that the creation of the program in FIRREA in 1989 was opposed by many, including the Banks. Not one of them would give it up now, particularly because of the great political support for the program. The strengths of the program are both its focus on low income multifamily projects through flexible financing approaches and its down payment assistance paired with homebuyer savings programs. These could be usefully expanded could be expanded many times over the current $150 million per year. I regret that the cash flow freed up by the completion of REFCorp obligation has not been redirected to expand AHP or created parallel programs for community development funding. The low and below cost funding provided by the Banks is a valuable contribution to well conceived affordable housing programs, especially because of the way that it has involved members in the distribution and partnership process. But the amounts involved are small and AHP should be seen for what it is -- a useful bi-product that exists because Congress mandated it -- rather than as a justification for the existence of the System.

Performance

The Federal Home Loan Banks operate a low risk, low return business. It does not take much of a dislocation to compress the operating margins and create problems. To their credit, and with a significant contribution from a conservative structure and regulatory regime, the Banks have avoided significant safety and soundness problems despite serious economic losses by their members, both in the S&L crisis of the '80s and the bursting housing bubble of the past decade. Some of that success has come from the Banks' preferred collateral priority, with losses ending up elsewhere, such as the deposit insurance system of the time. But in comparison to the collapse of Fannie and Freddie and the private

label securities market, the Banks have a good story to tell, grounded in that old fashioned idea of good credit discipline.

That does not mean that there have not been problems. The number of Banks operating under regulatory agreements is a testament to that. So it is important to identify the aspects of the Banks' performance that have given rise to the problems. Any financial institution can make errors that lead to trouble, and any regulator can miss the signs in one or another institution. But when so large a percentage of the entities experience similar problems, something in the structure or regulatory process probably has contributed to the problem
Here are some of my observations on performance issues:

Advances v. Investments. As I have previously mentioned, the core product of the Federal Home Loan Banks is the advance. It is the "hold in portfolio and fund" alternative to secondary market liquidity tools. It predated securitization and it retains vitality for a wide range of members in a wide range of circumstances. But its value to all institutions, especially to large ones, is an attractive price. Where so many of the funding alternatives for housing assets are government assisted (e.g., insured deposits, Fed funds, GSE securitization, FHA/VA guarantees, GNMA securitizations), advances must also reflect their government assisted funding and low risk through collateralization in narrow spreads. Before 1990, when the Banks operated in a closed savings institution, mandatory membership world, their only investments were Treasuries to provide liquidity, usually about 10% of assets. Since 1990, the pressures for dividends, price competition for advances, and increases in required capital levels have significantly increased the "investment" portion of the Banks' balance sheets. Despite rhetoric about mortgage-backed securities (MBS) ownership as supporting housing finance, the truth is that there are plenty of private buyers for these assets and the Banks' activity is much more a profitable arbitrage based on their cost of funds than pursuit of public purpose. But the current structure of capital and dividend expectations demand the earnings from these investments to balance the books. The market risks of these portfolios were always a concern and required the Banks to engage in substantial hedging activities (some of which is also required for longer-term advances, although those risks are largely covered by prepayment penalties). But there have also been a growing number of credit problems, especially in the recent crisis, in which putatively AAA securities have defaulted. The primary fault for these performance failures lies elsewhere—with the originators, securitizers and rating agencies—but the structural pressure for earnings is what brought these dubious securities onto the Banks' books. These pressures can and should be removed and investments reduced to what liquidity requires.

Dividends. Federal Home Loan Bank dividends have been a good deal for members based on the 20% risk based capital standard for Bank capital provided by Basel I and the ability to borrow the capital purchase through an advance levered at 20 to 1. The real return on Bank stock has always greatly exceeded the nominal rate. Dividends and advance prices are competitors for funds. The former favor those members who do not borrow, while the latter those that do. Should there be dividends at all? Certainly, this would drive away members with no real interest in borrowing, but it would mean that the cost to members of the capital needed to support the Bank would have to be funded by the price advantages of advances or the value of the line of credit for liquidity to non-borrowers. Dividends have been suspended at some Banks for substantial periods, so they are not indispensable. And the liquidity requirements embodied in Basel III (depending on how they are applied to access to advances), as well as the risk weighting of Bank stock, will have a lot of impact on the need for and level of dividends. But using dividends beyond the level needed to retain a balance in advance pricing is a mistake. Banks have

chased earnings to raise dividends. When they have done so, they have taken unnecessary credit risks that can and should be avoided.

Capital Levels and Structure. Do the Banks have real capital? And is it enough? Could it be too much? The growing, but still small amount of retained earnings is certainly "real capital." Gramm-Leach-Bliley sought to reform the capital structure to make the capital more permanent and more flexible, with only partial success. One aspect of the Banks that is a real strength is the ability to expand and contract in response to market demand. The Bank System demonstrated this dramatically at the height of the economic meltdown from 2007 to 2009. This requires the ability to expand and shrink capital in tandem with growth and decline in advances volume. So the activity-based portion of the capital structure is essential. And a core of retained earnings that "nobody owns" and that does not have to be serviced would remove one pressure to chase earnings. But to the extent that capital must be serviced through either dividends or advance prices, there is a danger of the level being too high as well as too low. When a financial institution has too much capital for its level of risk, it is pressed to seek higher risk assets to bring the risk and capital into balance. That is what the Banks have done and continue to do. You can try to control this by regulation, but it is very hard to prevent the constant search for an arbitrage that will plug the earnings gap—at higher than apparent risk. If Banks have only or primarily advances as the asset that serves their members directly (not through financial windfalls), then the level of capital should reflect the risk of advances and liquidity investments. This would remove the need for higher yielding investments and their attendant risks. This was mostly a theoretical problem until Banks started losing money on MBS investments. But now the risk is clear and should be addressed.

Multidistrict Memberships. The debate over multidistrict memberships is a product of the outsized importance of very large institutions. If they are not spread around the system through their various charters, their value as members, customers for advances and partners for AHP is concentrated in one Bank. In the past, large institutions without multiple charters viewed multiple memberships by their multi-charter colleagues as unfair and sought a change—not to eliminate the multiple memberships, but to make them available to all, without regard to charter location. In theory, and occasionally in practice, multidistrict memberships create moral hazard. Banks can be played off against each other by a common dominant member, and other Banks can be potentially saddled with greater risk under joint and several liability. But this issue is not really worth much time. It is a subset of the question of whether large institutions should be members at all. If so, the choices of which and how many Banks they can join could go either way, although the arbitrary fact of charter locations is a historical artifact that has little place in a world of nationwide banking. As for the risk of unfair leverage, and the benefit of interbank competition, both the Banks themselves and the regulator should be up to the task for avoiding abuse.

Mortgage Purchase Programs. A major innovation of my tenure as Chairman of the Finance Board and regulator of the Federal Home Loan Banks was the creation of mortgage purchase programs. But these programs have not been without problems, and they have never become more than a niche product of the Banks. Are they a mistake? At time of their creation, they addressed two defects in the housing finance secondary market—the oligopoly power of Fannie and Freddie over the secondary market access and the lack of "skin-in-the game" for mortgage originators. The Bank programs were designed to offer members a choice of outlets for their mortgages through one that made it more profitable to be a better underwriter. When the program was begun, it did not provide for an onward sale of the mortgage

portfolios as they accumulated on Bank balance sheets. However, we expected to follow through on this program by providing a securitization option for the Banks when the program reached the necessary scale. Our legal view was that the Finance Board had the authority to create that securitization option, based on a legal opinion that predated my tenure. Unfortunately, my successors chose not to act on that option and deferred the question to Congress and a study mandated in HERA, which effectively cut off access to liquidity for the program, a severely restrictive outcome. In addition, in 2001, one Bank chose an unstable capital scheme to fund its aggressive mortgage purchases and undermined its safety and soundness in the process. So the outcome of the experiment is mixed at best. But the future of these programs must take account of the new mortgage market reality. Fannie and Freddie are wards of the government and mechanics of whether and how to require mortgage originators and others to have "skin-in-the-game" remains a matter of dispute. The Banks should have the ability to engage in mortgage purchase programs to the extent that such activity fits properly into the housing finance structure that emerges over the next few years. They could have a big role, a specialized role, or no role at all. But the world of 1996 on which the current programs were based is gone forever.

Future Prospects

Except for a few stray references in the Administration's White Paper on GSE Reform, the Federal Home Loan Banks have been largely absent from the discussion of future housing finance structures. While it is characteristic of the Banks to shy away from controversy and stay in the background, I cannot see how a logical framework can emerge for the future without reconciling it with the role and structure of the Banks. (Perhaps my mistake is believing, or at least hoping, that we are headed for a "logical framework" for a $12 trillion segment of our economy.)

Here are some recommendations about choices that seem inevitable as part of a GSE reform or replacement debate:

Implied Guarantee. Most proposals for housing finance reform identify the problem of the "implied guarantee" that supported Fannie and Freddie—and the Federal Home Loan Banks. The taxpayers take an undefined risk for which no reserves or compensation is collected. When the guarantee is called upon, as it was for Fannie and Freddie in 2008, the taxpayers just pay the bill. Nobody wants that. Some would say "Either don't have a guarantee or make it explicit and fund it up front." But, as is true for almost every aspect of the housing finance markets, the problem is not so simple. For decades, the government explicitly disclaimed any responsibility for GSE liabilities. The markets thought otherwise and bet good money on it. The markets were right. Implied guarantees cannot be prevented even by words in a statute or on a bond instrument. They are created by conduct. And in the GSE world, the conduct was creating entities that issued obligations and knowing that the failure to pay such obligations would wreak havoc with arrangements of central importance to the government and the economy—like the stability of the housing market. In the discussion of replacing Fannie and Freddie, focus for any guarantee (or not) has been on the MBS issued. But what of the issuers? Proposers of MICs and MISICs and Guarantee Associations assure us that the entities will not be guaranteed, only the MBS. But they are wrong. If these entities have balance sheets and issue substantial debt, the markets are likely to assume that the entities are operating with the same implied guarantee on their debt (never mind the MBS) as did Fannie and Freddie—and the Federal Home Loan Banks. Which brings me to the crucial point: Federal Home Loan Banks need substantial balance sheets (unless perhaps they securitize

their advances) in order to fund the advances they provide to members. And they need to issue debt to fund those advances. So, does the government guarantee Federal Home Loan Bank debt (implicitly or explicitly), but not that of any Fannie and Freddie replacements? Can this be avoided by privatizing the Banks? Could the Banks survive in that form? Would their pricing work? For whom? In short, the handling of taxpayer liability seems to tie the Banks and Fannie and Freddie together with respect to debt issuance. How can there be fundamentally different treatments of similar structures? If implied guarantees are a mistake, and I think that they are, then the Banks need to go private or have their debt explicitly guaranteed—for a fee—or they need to do something completely different, like securitizing their advances. But then, what of those securities? Would they be guaranteed? I find the resolution of these questions conceptually and practically inseparable.

Portfolios. The issue of portfolios is closely related to the points just made about the implied guarantee. As for the mortgage portfolios, they could be securitized, so they are not the issue. As for the investment portfolios, they can be largely eliminated (except for the liquidity fund) if the dividend and capital pressures for higher risk and higher return were removed. But advances are assets on the books of the Banks. And they must be matched by liabilities. Unlike Fannie and Freddie where the MBS can be sold off and credit risk transferred to mortgage insurers and other properly capitalized private entities that do not need debt, the Banks need debt to fund their advances. The all-government solution is to replace the Banks with FDIC guarantees on depository debt. The all-private solution is to remove all the trappings of government, including joint and several liability, the super lien, territorial and membership limits, and AHP, and let the 12 Banks each function as wholesale banker's banks, competing with each other and maintaining AAA credit ratings based on the quality of their capital and collateral. That sounds daunting to me. So that drives us back toward either an explicit guarantee of debt or securitized advances that are themselves guaranteed. One response to all of that is to conclude that the Banks are fine as they are, no changes are required, let them just keep on doing what they are doing. That may be true enough, but in light of all that has happened since 2007 including the demise of Fannie and Freddie, how can the Banks avoid the continuing specter of implied guarantees that will create unfunded claims on taxpayers in the future?

Covered Bonds. The European version of GSE funding for mortgages has been the covered bond. They are issued by banks on the collateral of specific mortgages held in portfolio on which the bondholders have the first claim. The regulation and support of the banks in Europe make this arrangement far less "private" than it may first appear. But the success of this approach (albeit under more stress now than in the past), has encouraged support for replicating it here. Several hurdles make this a less-than-perfect solution: First, the structure requires the financial institution issuing the bonds to hold the underlying securities in portfolio on their balance sheets, which presents a multitude of issues such as hedging long term fixed rate mortgages with varying prepayment patterns. Second, this structure sets up competition between bondholders and the FDIC for claims on assets of failed banks. But it seems that the effort to import this structure (with all respect for Congressman Garrett's efforts) is unnecessary. We have had a suitable structure all along that has solved the two problems cited and some others as well. That structure is the Federal Home Loan Banks. They issue bonds backed by the collateral of mortgages (and other assets) pledged by members. The activity opens up funding for portfolio mortgage holdings for banks of all sizes, not just those large enough to issue their own covered bonds. Protection for the bondholders is cross-collateralized across the entire Federal Home Loan Bank System, not just the specific group of mortgages supporting a European covered bond. The hedging challenges are alleviated by the flexibility of funding available to members from the Banks. And the

competition with the FDIC has been long resolved by Congress through the super lien. Covered bonds are not offered as a replacement for securitization, but as a supplement. Yet, what would they really add to the system that the Banks do not offer their members? It appears that the reason that covered bonds never took root here is that we already have them in a more flexible form.

New Products. I have noted how the issues of portfolios and guarantees that arise in the housing finance reform context have implications for the Federal Home Loan Banks. But there are positive as well as negative implications. Assuming that the Banks are a valuable aspect of the financial system, providing flexible liquidity seamlessly in good times and bad, that suggests retaining them and accepting the need for a funded balance sheet of assets. One of the challenges of reforming the single family mortgage market without taxpayer risk is the perceived need for portfolios to hold midmarket multifamily mortgages and hard-to-securitize affordable housing mortgages originated by nonprofit community lenders. Building portfolios into the successors to Fannie and Freddie to address this need seems risky in light of the temptations such portfolios have presented in the past. But if the Banks are sticking around, and if they must have portfolios to function, and if they have a cooperative structure that reduces conflicts of interest, and if the members and the AHP partners are the main sources of such multifamily and affordable mortgages, why not look to the Federal Home Loan Banks to fill this role. And to the extent that Fannie or Freddie or both have special expertise, this can be transferred to the Banks in some orderly way.

Membership. Should membership be restricted to community banks or should advances be capped to limit big-bank access? In my opinion, this is a question for community banks. Keeping such institutions competitive and available to communities, especially for small business and economic development lending is a very important policy objective. The contribution of community banks to local credit access is a unique characteristic of the American financial system, and the Federal Home Loan Banks provide liquidity tools that facilitate their activities. However, the presence of large members provides lower cost-of-funds benefits that must be balanced against the competitive benefits of excluding them. If the community banks were clamoring for "their own" system, that would matter. That does not seem to be the case. However, if the larger members remain in the System, their use of advances should be more targeted. For community banks (say $10 billion in assets or below, defined at the holding company level), I would allow the Banks to provide general liquidity support by accepting any creditworthy collateral Above this asset level (again based on holding companies), I would significantly restrict the purpose of borrowing by regulating eligible collateral. While any collateral could be pledged for credit purposes, borrowing would have to involve the pledging of specific types of assets to correspond to advances. I envision a restriction to whole residential mortgage loans (single or multi-family). Perhaps certain kinds of economic development whole loans could also be included. But MBS and other liquid assets could not satisfy the advances-eligibility criterion, but might be used for over-collaterization purposes. This approach would limit the use of the Banks by large institutions to assets that need the liquidity support if they are to be held in portfolio. There might be a liquidity-crisis exception to this limitation, but providing large banks with a general liquidity source at a subsidized cost of funds is not justified. With this limitation on the purposes of advances—to facilitate community lending through small bank liquidity and portfolio housing lending through targeted support—any explicit guarantee extended to MBS could be justified as well for Federal Home Loan Bank debt issuances. As to multidistrict membership under this model, it should certainly be permitted for holding companies to the extent of deposits drawn from particular districts, irrespective of charters. It might even be wise to require multiple memberships for holding companies above a certain size to reduce the

concentration of per member borrowings at individual Banks. Such a requirement would also eliminate the risk of choices about membership being used to extract concessions from Federal Home Loan Banks competing for large members.

Thank you for the opportunity to present these observations and recommendations. I will be pleased to respond to questions from Members of the Subcommittee.

United States House of Representatives
Committee on Financial Services

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Bruce A. Morrison	None
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?
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