Statement of

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Mr. Chairman, Ranking Member Kanjorski, and Members of the Committee, I appreciate the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks (Council) about the Federal Home Loan Banks (FHLBanks) and legislative proposals to reform regulation of the housing government-sponsored enterprises (GSEs). My name is David Hehman and I am President and CEO of the Federal Home Loan Bank of Cincinnati (Cincinnati FHLBank).

At the outset I would like to commend you, Chairman Baker, for your commitment and hard work to ensure the GSEs have a truly world class regulator with the necessary regulatory tools to ensure that the GSEs fulfill their missions in a safe and sound fashion. Likewise, Ranking Member Kanjorski, I commend you for your strong support of the Federal Home Loan Bank System (System) over the years, and your commitment to ensuring that the System operates in a safe and sound manner with the best corporate governance practices. The Council, which represents all twelve Federal Home Loan Banks, believes that it is important to resolve the legislative uncertainty and proceed to the enactment of meaningful regulatory reform legislation as soon as practicable.

FHLBank Overview

The FHLBanks were created in 1932 to support America's housing finance system through its member thrift institutions. With the expansion of members to include commercial banks and credit unions, the FHLBanks now play an even greater role in the nation's housing finance and community lending system. Member institutions use the FHLBanks' advance programs to meet the mortgage and community lending needs of their local markets, and utilize our Affordable Housing Programs to help thousands of low-income families obtain decent housing. In addition, the FHLBanks' mortgage purchase programs provide our members, particularly smaller-sized institutions, a desirable secondary market alternative.

The System is unique, comprised of twelve regional FHLBanks, their 8,100 member financial institutions and the Office of Finance that issues debt on behalf of the twelve regional FHLBanks. The regional FHLBanks are overseen by an independent regulator, the Federal

Housing Finance Board (Finance Board). While the System shares a congressional charter and housing mission with Fannie Mae and Freddie Mac, the FHLBanks are fundamentally different in both structure and perspective from these institutions. The structure is one of twelve regional FHLBanks and their members that form a cooperative driven by customer credit demand. And while the twelve FHLBanks are independently owned and operated, they share joint and several liability for the System's debt.

The mission perspective of the System is also different and broader than that of the other housing GSEs. The FHLBanks are major providers of advances funding for housing and community development. The value of FHLBank advances stems from both the daily available liquidity and the actual provision of short- and long-term funding at capital market rates. Recent research sponsored by the Council into the impact of FHLBank advances on mortgage lending has shown that members of the System hold a significantly higher share of their assets in housing and community development loans compared to non-members. These findings confirmed those in an earlier study (July, 2002) sponsored by the Federal Reserve Bank of Cleveland. These studies show a strong correlation between the use of advances and the members' willingness and ability to hold mortgage-related assets. Quite simply, the studies confirmed the System is doing exactly the work the Congress had intended.

Legislative Overview

Congress has historically taken an active role in defining the mission and structure of the System. Two critical pieces of legislation shaped today's FHLBanks. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) expanded membership to include commercial banks and credit unions with a demonstrated commitment to housing finance. FIRREA also created the System's Resolution Funding Corporation assessment on FHLBank earnings and mandated the Affordable Housing Program through which each FHLBank sets aside 10 percent of net earnings annually for the creation of affordable housing throughout the nation. As a direct result of this program the FHLBanks have awarded over $2.0 billion to create more than 400,000 affordable housing units since 1990.

Title VI of the Gramm-Leach-Bliley Act of 1999, sponsored by Congressmen Baker and Kanjorski, established universal voluntary membership; provided for a permanent capital structure; expanded the types of collateral that community institutions can pledge to secure advances, and increased the independent corporate governance of each FHLBank.

Ten (10) FHLBanks, including Cincinnati, have implemented newly required capital stock plans. This monumental task occurred well within the legislative time frame, and is due in no small part to the strength of the System's independent regulator and the commitment of the boards of directors at each FHLBank. The new capital structures have left the System with approximately $42 billion of capital with an aggregate capital-to-assets ratio of approximately 4.5 percent as of year-end.

These two pieces of legislation, combined with the performance of the FHLBanks in the marketplace and customer demand for FHLBank products, resulted in considerable growth over the last decade. At year-end 2004, the FHLBanks had combined total assets of approximately $930 billion compared to $241 billion a decade ago. This growth is a direct result of an increase of more than 2,800 members in the past 10 years to just over 8,100.

Independent Regulator

The FHLBanks can best support and build upon our successful record with a strong, independent regulator, engaged corporate governance, and effective risk management. Under our current regulatory regime, the Finance Board's primary duty is "to ensure that the FHLBanks operate in a financially safe and sound manner." The Finance Board is not limited by funding constraints in carrying out its declared focus of ensuring the FHLBanks' safety and soundness. Its funding is provided by assessments on the FHLBanks that are not subject to review or challenge by the FHLBanks. Finance Board regulations govern a broad range of FHLBanks' operations including advances pricing, risk management, capital plan approval, directors' responsibilities and new business activities. The Finance Board also collects and monitors financial and risk management data from the FHLBanks each month, performs ongoing reviews of all aspects of the FHLBanks' operations and conducts annual on-site examinations of all 12

FHLBanks. The FHLBanks all believe that it is essential to maintain a strong, independent regulator with the resources to ensure the FHLBanks' continued safety and soundness as well as to oversee the housing mission. This independence has been a key element in the long-term safe and sound track record of the FHLBanks.

Corporate Governance

Finance Board regulations require the FHLBanks' boards of directors to fulfill the typical corporate director duties. These include the responsibility to select and oversee management, ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, a member products policy that details the FHLBank's credit and pricing policies, and the responsibility to approve the FHLBanks' annual operating and capital budgets and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. Finance Board 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, credit policy, human resources, and housing oversight functions. The various elements of the FHLBanks' corporate governance structure result in boards of directors that are active, knowledgeable, engaged, and fully aware of their responsibilities.

Risk Management

As one of 12 independent institutions, the Cincinnati FHLBank is responsible for its own risk management activities. Our risk profile is guided by a number of regulatory factors common across the System. The FHLBanks are required by regulation to adopt a Financial Management Policy which governs investment, funding, and hedging activities and overall risk limitations. FHLBanks are subject to a minimum 4.0 capital-to-asset ratio as well as a risk-based capital requirement. The FHLBank minimizes credit risk by over-collateralizing advances, limiting investments to highly rated securities, and establishing appropriate risk sharing features for mortgage purchase programs. No FHLBank has ever suffered a credit loss on an advance to its members in its 72-year history.

The one potential source of risk to the FHLBanks is interest rate risk. Each FHLBank uses sophisticated, high quality financial models to continually assess the magnitude of the risk to earnings and the estimated market value of equity and earnings from changes in interest rates, mortgage prepayment speeds, and other market variables. A part of this process does involve the use of various derivatives such as interest rate swaps. Derivative positions are marked to market on a regular basis and appropriate collateral is in place at all times. Financial management policies limit the use of derivatives to hedging only. Like all users of derivatives, the FHLBanks have also learned to deal with the complex accounting rules required for these transactions.

Beyond the board-established policies which conservatively limit a FHLBank's risk profile, the cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk exposure in search of higher returns. The primary mission of the cooperative is to provide member institutions the funding and financial services they need to meet the credit needs of their communities. At the same time, the FHLBank must generate an adequate dividend return to member shareholders that meets their opportunity cost of investing capital in a low risk enterprise. Rates of return on FHLBank stock have averaged in the neighborhood of three to five percent in recent years, far below the return expected from publicly traded corporations.

SEC Registration Status

At its June 23, 2004 meeting, the Federal Housing Finance Board voted 4-0 to approve a final rule to require each FHLBank to register a class of its equity securities under Section 12(g) of the Securities Exchange Act of 1934. This registration would subject the FHLBanks to the SEC's disclosure regime – requiring the FHLBanks to file quarterly, annual, and supplemental financial disclosures with the SEC.

The final rule requires each FHLBank to publicly file their first 1934 Act documents – Form 10s – no later than June 30, 2005, and to have their registrations effective no later than August 29, 2005. The FHLBanks are currently engaged in ongoing negotiations with the SEC staff to address issues associated with FHLBank SEC registration – many of which stem from the unique cooperative nature of the FHLBank System. To underscore the FHLBanks' cooperative structure, the Council has supported some technical language in the Senate version of the GSE bill which we would request you to consider as well. While the System already has in place a comprehensive SEC-like financial reporting system, providing SEC reports will further the process of providing transparent statements by which the public can judge the activities of the System.

Guiding Principles for Legislative Reform

The combination of congressionally determined financial requirements, an independent regulator, engaged boards of directors and extensive risk management tools has proven to be a successful model. The 12 FHLBanks currently provide over $580 billion of advances funding to their member institutions, serving virtually every neighborhood in America. The flexibility of the FHLBank model has allowed for adaptation over time in response to changing financial industry conditions and market environments.

Recognizing that there were very serious legislative efforts to reform regulation of the GSEs in the last Congress and that there was a great likelihood that the Federal Home Loan Banks would be included in this legislation, the Council adopted "Guiding Principles" for legislative reform. With respect to the Federal Home Loan Banks, we believe that these same principles should apply to regulatory reform legislation under consideration in the 109th Congress:

First, it is critical that the legislation preserve the FHLBanks' mission of providing cost-effective funding to members for use in housing finance and community development; encouraging regional affordable housing programs, which creates housing opportunities for low- and moderate-income families; and supporting housing finance through advances and mortgage programs.

Second, it is critical that the legislation provide for a strong, independent regulator. This regulator should be protected by Congress, as other bank regulatory agencies have been – such as OTS and OCC –from intervention by any other agency on policy, rulemaking, application, adjudicative and budget matters. The new regulator must be given all of the authority and regulatory tools necessary to ensure that FHLBank advance and mortgage programs can operate going forward in a safe and sound manner that is consistent with their mission.

Third, it is critical that the legislation preserve the role and function of the Office of Finance. The legislation must ensure that neither the U.S. Treasury, nor the independent GSE regulatory unit, has the ability to impede or limit the FHLBanks' access to the capital markets without cause.

Fourth, it is critical that the legislation maintain the unique characteristics of the regional structure of the 12 FHLBanks and provide a regulatory structure designed to recognize these unique characteristics. The legislation should maintain the devolution of governance powers to the individual FHLBanks' boards of directors. In the event that the legislation does not provide for the appointment of non-member directors, we believe that it is important from the perspective of good corporate governance to provide for a category of non-member directors, including community interest directors, and a process for their selection. The Council also unanimously supports the elimination of director compensation caps, as well as the extension of terms for all directors from three years to four, as was included in regulatory relief legislation (H.R. 1375) passed by the House in the last Congress.

Conclusion

The Council of Federal Home Loan Banks supports legislative efforts to achieve a world class regulator for the GSEs. From the point of view of the FHLBanks, we believe it is critical that such legislation preserve the mission of the FHLBanks, provide for a strong, independent regulator, preserve the funding for the FHLBank System and preserve the unique regional cooperative nature of the FHLBank System.

Mr. Chairman, thank you for the opportunity to address the Committee on this important matter. I will be happy to answer questions at the appropriate time.