# Testimony of

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**on**

# "GSE Reform and the Federal Home Loan Bank System"

**before the**

**Capital Markets, Insurance and**
**Government Sponsored Enterprises Subcommittee**

**of the**

**Committee on Financial Services**

**of the**

**U.S. House of Representatives**

**on**

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Good Morning Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee. My name is Weller Meyer and I am the President and CEO of Acacia Federal Savings Bank. I welcome the opportunity to testify before the Subcommittee on the Federal Home Loan Bank System.

Acacia is a $995 million community bank in Falls Church, Virginia. Acacia's primary business is originating mortgages for families. We originated 1,187 in mortgages in 2004, for a total of $327.7 million. We are a member of the Federal Home Loan Bank of Atlanta and we have $244.1 million of advances outstanding, which comprises 26.7 percent of our liabilities. We could not offer the mortgage products we did if we did not have access to FHLBank advances. We rely on the FHLBank System day in and day out and we have as long as we have been a member.

As an indication of the importance of the FHLBank System to the liquidity and funding of community banks, a recent study by America's Community Bankers indicated that advances comprised 21 percent of the liabilities for member banks active in the System.[1] Further, in the recent Survey of Community Bank Executives conducted by Grant Thornton, 56 percent of the respondents reported that they used FHLBank advances as a source of funding in 2004 and 63 percent expect to use them in 2005.[2] These numbers confirm the importance of the FHLBank System to a broad base of community banks and are an indication of the evolution of the System in the past 15 years.

Community banks have an acknowledged history of superior performance in lending to low income and minority borrowers. For instance, studies reported by the Federal Reserve have shown that "depository institutions have higher portfolio and market shares than the two for-profit government-sponsored enterprises that are active in the secondary market, the Federal National Mortgage Association ('Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac")."[3] The FHLBanks support this business with advances and with programs, including the Affordable Housing Program, which provide any number of examples of successful public/private partnerships. Community banks also have a strong record of lending to first time homebuyers. In 2004, according to a survey conducted by America's Community Bankers, respondents reported that 12 percent of first mortgage loans were made to first time home buyers.[4] These activities would not have been possible without the access to advances and the local programs that are made possible because of the FHLBanks.

Further, like many other banks, Acacia's investment in FHLBank stock is the single largest investment that we have. As a member of the FHLBank of Atlanta, the safe and sound operation of the Bank and the safety of my investment are critical. As a banker, I understand the importance of good supervision and oversight for both safety and soundness and mission. I support an operating model for the FHLBanks that is founded on the current statutory authorities and a strong regulator that provides oversight. As I mentioned, Acacia is a member of the FHLBank of Atlanta, but because of the cooperative organizational structure and the joint and

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[1] *Washington e-Perspective*, America's Community Bankers, March 9, 2005
[2] *Twelfth Annual Survey of Community Bank Executives*, Grant Thornton, March 2005
[3] Volume 82, *Federal Reserve Bulletin* Number 12: page 1077
[4] *2005 Real Estate Lending Survey*, America's Community Bankers, February 2005

several liability of certain activities of the Banks, I am interested in the activities of all of the FHLBanks and how those activities could affect my investment and my ability to obtain funding.

The System is a member-owned cooperative that has evolved over time but that continues to provides a much needed source of funds for the majority of its member institutions. Advances make it possible for community banks to make sound home loans that may not conform to the strict criteria of the secondary market. FHLBank advances also provide an important alternative funding source for community banks that choose to keep loans they originate – whether conforming or not – in their own portfolios. Community banks rely on the advance window for borrowing where other funding alternatives are not readily available. In considering the future of the System, from a member and user perspective it is important to retain the highly successful cooperative organization of the System and the ability of the FHLBanks to fund the mortgage originations and community development activities of its member institutions.

As the debate progresses, and Congress considers the concerns common to the FHLBank System and the secondary market Government Sponsored Enterprises ("GSEs"), Fannie Mae and Freddie Mac, I urge you to ensure that the legislation provides a new regulatory structure that recognizes the unique and successful business model of the FHLBank System. Unlike Freddie Mac and Fannie Mae, the System is a cooperative owned by its member institutions. The FHLBanks' stock is not publicly traded and does not fluctuate in value. In addition, each of the FHLBanks is jointly and severally liable to all the others. Fannie Mae and Freddie Mac are publicly held companies. Each of these GSE business models has their strengths. Any revised regulatory system should continue to respect those differences, while advancing the common goal – to maintain their financial safety and soundness.

The core function of the FHLBank System is to provide vital liquidity to its member financial institutions in support of residential and community-based lending. The FHLBanks should continue to focus on the funding of housing lending, while accommodating the new, expanded range of collateral permitted to community financial institutions (as defined in the Gramm-Leach-Bliley Act to be FDIC-insured depositories under $500 million in total assets).

**Background**

The FHLBank System was established in 1932 as a source of liquidity for savings and loan associations which were the primary home mortgage lenders in America. These institutions were required to be members of the individual FHLBank in their regions and were required to collateralize the advances with home mortgage loans. At the time, these institutions were generally unable to obtain funding by any other means than deposit gathering. Without the System providing advances at reasonable cost to these institutions, millions of Americans would not have been able to become homeowners.

Even with the creation and expansion of the secondary market for mortgage loans, many lenders would not be able to serve their customers without funding from the FHLBanks. This is evident in the continual reliance on advances funding by member institutions. The loans these lenders make are frequently non-conforming or may be part of a targeted program. Community banks also often do not want to sell all of their loans to the secondary market because they prefer to maintain customer contact and service. The System provides a source of funding for those institutions wishing to retain those loans in portfolio. This is still true today despite the growth of the secondary market and the changing business of community banks.

In 1989, as part of the Financial Institutions Reform, Recovery and Enforcement Act, the System membership was opened up to commercial banks and credit unions, and the operations of the individual FHLBanks were separated from the supervisory functions that they had provided since 1932. The current regulator, the Federal Housing Finance Board ("FHFB"), was created. In 1999, the System changed again with the imposition of new capital requirements and expanded collateral options.

The FHLBank System has grown with the addition of commercial banks and credit unions. The organization and structure of each of the Banks has evolved from an entity that was a regional supervisor as well as a provider of back office services and advances to a System of 12 Banks. What has not changed is the cooperative structure of the System and the requirement that only members can access advances.

In the mid 1990's the FHFB, working with several of the FHLBanks, developed mortgage programs that are generally referred to as acquired member asset ("AMA") programs. Currently there are two programs, the Mortgage Partnership Finance and the Mortgage Purchase Program. These programs were developed to provide the members and the Banks that participate an alternative risk management and mortgage funding strategy. The members are able to sell loans to the FHLBank under terms established in the programs.

As the programs evolve to meet needs of the Banks that developed them and the members who use them, some market participants have discussed permitting securitization of the loans as part of the programs. Presently, there are no proposals from the Banks before the FHFB to permit such securitization. I strongly believe that this is a topic that must be studied before any action is taken, and that securitization be considered only in the context of a public review process conducted by the designated federal regulator.

The FHFB has evolved as a regulator. In the past few years, a greater emphasis has been placed on the safe and sound operation of the Banks and on the supervision of the System. The examination staff has grown in number as well as in expertise as a reflection of the greater understanding of the importance of having a strong regulator. Any legislation must continue this trend.

**The Future of the System**

Any legislative debate should reflect the differences between the Federal Home Loan Bank System and Fannie Mae and Freddie Mac. Unlike the other housing GSEs, the FHLBank System is a cooperative made up of twelve independent FHLBanks with joint and several liability. The FHLBanks, out of the proceeds from net income, operate statutorily mandated affordable housing programs and are responsible for paying off the RefCorp bonds that were used to help resolve the 1980s savings and loan losses. Each FHLBank is primarily capitalized through the required purchase of stock by its member institutions. FHLBank stock is not available to the public and is not tradable, even within a FHLBank, without the express permission of the FHLBank. The stock is issued and redeemed at a par value of $100 and does not fluctuate in value.

As the debate over the appropriate regulatory scheme for the FHLBank System develops, I cannot stress strongly enough the importance of maintaining the cooperative nature of the Federal Home Loan Bank System under a new structure of regulation and supervision of the System and the housing GSEs. The cooperative structure of the System is essential to preserving the benefits that member institutions provide to communities and families and fund through advances. One of the many strengths of the System is the ability of each of the 12 Banks to develop and tailor products that meet the changing and diverse needs of their own members. Advances are used to fund loans that may not be conforming loans that the member institution may retain in portfolio. The AMA programs also have provided a needed outlet to community banks.

The FHLBank System needs a strong, independent regulator that has the authority to supervise the individual Banks using the current statutory framework of powers. Any new regulator of the FHLBanks must have the authority to maintain the Banks' access to the capital markets and their current well-defined mission to support the mortgage finance, affordable housing, and community development activities of member banks. The advance programs of the FHLBanks ensure that homebuyers and others in the community have ready access to home mortgage and community financing through FHLBank members. The fact that the FHLBank System members are the leading lenders to lower income and minority borrowers is testament to the success of the System and its mission.

The regulator must be flexible and equipped to address the differences in the business and operation among the Banks. The new regulator must also work within the current statutory authorities, which include safety and soundness and mission oversight. It is also critical that the financial obligations imposed on the Banks by Congress are able to be met.

In 1989, two assessments were placed on the earnings of the System. The first, the Affordable Housing Program ("AHP"), is funded out of contributions from the net income of each FHLBank. The total contribution from all FHLBanks is required to be a minimum of $100 million or 10 percent of earnings each year. This money is then allocated based on an application process developed by the FHFB. The projects that receive funding include many housing and community development projects. This program is a good example of how special affordable housing and community partnerships can be funded by an assessment on the System. I strongly support the very successful AHP as it is structured and would not support any changes.

The second assessment on the System is the obligation toward repayment of the interest on the RefCorp obligations. Each bank must pay an amount equal to 20 percent of net earnings to repay the obligations incurred in the 1980's. These assessments are a legacy obligation of the System and are part of obligations which Congress imposed on the System, along with other mission requirements. This costly obligation will not expire until 2030.

Congressional efforts to strengthen the regulation of the FHLBank System are important, but it is important to recognize that improvements in regulation are expected primarily from synergies and expertise that should be available in a new regulatory structure. The current regulator has broad powers to promulgate and enforce all regulations and orders necessary to ensure that safety and soundness and mission requirements are fulfilled. It is important that the new regulator effectively exercise this authority to ensure the safe and sound operation of the Banks and to preserve the core mission of the System of providing liquidity to community banks. The characteristics for any new regulator must include that the regulator:

- Be independent and not subject to the Congressional appropriations process;
- Be funded in a manner that provides that the System's assessments be allocated predominately to the regulation and supervision of the System;
- Possess similar supervision and enforcement powers to those of federal banking regulators to maintain safety and soundness and guard against systemic risk;
- Be organized with a strong emphasis on preserving the current statutory authorities and the cooperative structure of the System;
- Recognize the unique characteristics of the System; and
- Not impede or limit the FHLBanks' access to the capital markets.

The independence of the future regulator is an important element. A structure that provides autonomy will insulate the regulator from concerns about unintended political influence. The ability to fund operations without having to resort to the annual Congressional appropriations process is critical. In addition, the assessments that the regulator makes on the FHLBanks must be used to examine and supervise the FHLBanks.

The FHFB has powers and authorities similar to those of the banking regulators in the areas of capital, activities and supervision. Such authorities should be preserved and to the extent that efficiencies can be gained by combining supervision in discreet areas, the regulator must recognize the differences in the regulated entities. Substantive areas in which there may be synergies include interest rate risk management and accounting guidance.

A review of the structure and power of the regulators is important. It is also critical that as the System evolves, the regulator, the members, the analysts, the purchasers of the debt and other interested parties be able to have access to information about the Banks.

The FHLBanks' stock and debt instruments should be subject to transparent disclosures that are appropriate for this unique GSE. In June 2004, the FHFB issued a final rule requiring that each Federal Home Loan Bank register a class of securities with the SEC under the Securities Exchange Act of 1934. The disclosure scheme that has been established for public companies contains a number requirements with which it is difficult for a cooperative System to comply. I support the inclusion of certain specific securities law exemptions in any legislation. Such exemptions will make it easier for the FHLBanks to register and comply with the disclosure requirements, but will also make it easier for interested parties to understand the disclosures and the business of the FHLBanks. In particular, I support a specific provision that would exempt the FHLBanks and the System from certain requirements of the SEC's Regulation FD.

As part of SEC registration, each of the Banks must comply with a number of provisions of the Sarbanes Oxley Act, including Section 404. Each FHLBank is developing the systems, policies and procedures necessary to comply with the internal control requirements. In addition, each FHLBank is drafting disclosures that must be included in the registration statements regarding financial information, operations and corporate governance. Each FHLBank is ensuring that its staff has the expertise necessary to draft the disclosures and to meet regulatory requirements.

Going forward, the public nature of the disclosures and the transparency that results from the ongoing reporting requirements will result in a better understanding of internal controls, corporate governance, and financial condition of each of the FHLBanks and the System as a whole.

The current corporate governance structure of the FHLBank System has been established by statute. Over the years certain governance functions have been devolved from the regulator to the FHLBanks themselves. I believe that the composition of the Boards of the each of the FHLBanks is a critical element in ensuring that the governance of the FHLBank is undertaken in an appropriate manner. As each of the FHLBanks, and the System in general, has evolved into more sophisticated financial institutions, I believe that financial, business and operating expertise must be demonstrated by the Board of each FHLBank. I support careful consideration of changes to the statute, regulation, and practice that will ensure that each FHLBank will have a Board that is composed of members with a stake in the System who understand the commitment and importance of serving on a FHLBank Board. As the financial structure of the Banks becomes increasing complex, it is important to have strong financial qualifications for all directors so that they can effectively oversee the FHLBanks' operations.

I wish to again express my appreciation for this opportunity to testify on this important issue. The future of the FHLBank System is important to the day to day operations of many community banks, including Acacia and communities they serve. I look forward to working with you and the members of the Subcommittee as the legislative process unfolds.