Testimony of Ronald A. Rosenfeld
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Thank you, Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee.

Today represents my first appearance before this subcommittee. I am honored to appear before you, and I thank you for the opportunity to discuss the Federal Home Loan Bank System and reform of the government sponsored enterprises (GSEs).

The opportunity to serve at the Finance Board is a great privilege. It has also been my privilege to work in the public sector at both the state and federal level, and most recently, as president of Ginnie Mae. I have also spent a good part of my career in the real estate development and investment banking businesses. As Chairman of the Finance Board, I testify today as a regulator who is committed to ensuring that the Banks operate in a financially safe and sound manner, and carry out their housing finance mission.

The 12 Federal Home Loan Banks are owned by their members -- more than 8,000 financial institutions -- primarily commercial banks, savings associations, insurance companies, and federally insured credit unions. The Banks serve the public by promoting the availability of housing finance, primarily by providing low-cost loans, commonly known as "advances," to their members.

Mr. Chairman, I would like to begin by providing this subcommittee with an update on the Banks registration with the Securities and Exchange Commission (SEC). The Banks are required to file registration statements by no later than June 30, 2005, and to have their registrations effective by no later than August 29, 2005.

Finance Board staff has been working with the Banks to ensure that registration is accomplished in a smooth and efficient manner. Over the past year, the Finance Board issued three Advisory Bulletins to the Banks to help guide them through the registration process. To date, ten of the Banks have filed draft Form 10s with the SEC and nine of those Banks have received comment letters from the SEC.

On the supervisory front, last year, the Finance Board entered into two supervisory "written agreements" — one with the Federal Home Loan Bank of Chicago and the other with the Federal Home Loan Bank of Seattle.

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

Under the written agreement, the Finance Board required the Seattle Bank to hire independent third parties to conduct reviews of board and management oversight and the Bank's risk management processes. Those reviews are under way. In addition, the Finance Board required the Bank to provide it with an acceptable three-year business and capital management plan.

In considering its strategic alternatives, the Bank's Board of Directors and senior management have decided to focus on the company's traditional mission assets, called "advances." They are developing strategies, subject to Finance Board review, that will be designed to improve the Bank's long-term financial position by decreasing its exposure to interest-rate fluctuations. This will likely include the development of an exit strategy for the Mortgage Purchase Program, which will enable the Bank to lower its overall risk profile and reduce its operating cost structure.

Previously, in June 2004, the Finance Board entered into a written agreement with the Federal Home Loan Bank of Chicago. That agreement addressed various shortcomings in the Bank's governance, risk management, internal audit, capital management, accounting, and financial recordkeeping practices. Last month, the Finance Board accepted the Bank's three-year business and capital plan. The agreement also called for the Bank to maintain a 5.1 percent capital ratio and to engage an independent third-party to review the Bank's management and board governance, as well as the Bank's risk management, accounting, internal audit, and financial recordkeeping practices.

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

Now, let me summarize briefly four key supervisory initiatives and priorities for 2005 and offer a brief comment on GSE reform.

First, interest rate risk monitoring is at the top of our supervisory agenda. Interest rate risk is an inherent and significant risk facing the Banks owing to the nature of their business. Last year, we issued Advisory Bulletin 04-05, *Interest Rate Risk Management*, which describes supervisory expectations for the prudential management of interest rate risk.

As a follow up to that bulletin, we recently began requiring the Banks to submit to the Finance Board quarterly reports that show the Banks' market value estimates of assets, liabilities, and shareholders' equity under a range in interest rate scenarios.

To further buttress our interest rate risk program, this year we will expand our use of risk modeling technology to measure "off-site" the interest rate risk of the mortgage portfolios of each of the 12 banks.

Second, this year we initiated a program to visit each Bank, on a quarterly basis, between our annual on-site examinations. These visits are conducted by the examiner-in-charge of each Bank and one or two other staff members. The visits give us the opportunity to follow-up on examination issues and other developments, including the Banks progress in responding to regulatory initiatives such as SEC registration.

Third, we have directed our examiners to place increased emphasis on two essential elements of sound banking: corporate governance and risk management. In addition, our examiners will continue to give close scrutiny to the accounting practices, particularly the hedge accounting practices of the Banks.

And fourth, we intend to provide additional guidance in with respect to the Affordable Housing Program, particularly with respect to the operation of the homeownership set aside program. A report summarizing key findings from our review of the program will be available shortly.

Finally, regarding reform of the housing GSEs, there can be little debate over the need to have the very best supervision and regulation. On that, I suspect we can all agree. So, the issue comes down to whether there will be real GSE reform. Real GSE reform consists of equipping the regulator with the powers that are most critical to providing effective and thorough oversight. In my view, a regulator must have a complete arsenal of enforcement powers, including but not limited to, freedom from the appropriations process, the authority to approve new business activities, and receivership authority. As for the structure of the regulator, the Administration has spoken in its 2006 budget, and a clear consensus has emerged in support of one regulator.

I would note, however, that there are fundamental differences between Fannie Mae and Freddie Mac on the one hand, and the FHLBanks on the other. For example, Fannie Mae and Freddie Mac are shareholder-owned enterprises that focus on providing credit guarantees on pools of mortgages. They are in the mortgage securitization business, which they conduct on a nationwide basis. In contrast, the Federal Home Loan Banks are regionally based, member-owned, cooperatives that provide low-cost financing to their members. They do not securitize mortgages. Those differences should be accommodated.

Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, thank you for this opportunity. I would be pleased to answer your questions.