Testimony of John T. Korsmo,
Chairman, Federal Housing Finance Board,
Before the House of Representatives' Committee on Financial Services
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Good morning, Chairman Oxley, Ranking Member Frank, and distinguished members of the Committee. Thank you for inviting me to be part of this panel today on H.R. 2575 and the Administration's proposals regarding government sponsored enterprises.

Over the past year and a half, my colleagues and I at the Federal Housing Finance Board have undertaken a disciplined, continuing, and, I believe, successful effort to improve the agency's supervision and regulation of the Federal Home Loan Banks.

This process has been instructive, providing many lessons that I believe may be of value to you as you consider the best ways to strengthen government sponsored enterprise (GSE) oversight. Allow me to highlight several of these lessons.

First, a GSE safety and soundness and mission regulator should today – and for the foreseeable future – concentrate on understanding and keeping pace with the rapidly evolving mortgage finance sector.

Second, a GSE safety and soundness and mission regulator should have specialized knowledge of the business and risks of the enterprises it supervises.

Third, a GSE safety and soundness and mission regulator must guard its independence in establishing standards and in conducting examinations so as not to revert to a failed model of mixing supervision duties with other mandates.

Fourth, a GSE safety and soundness and mission regulator should possess all the tools and enforcement authority granted to commercial bank and thrift regulators.

And, finally, a GSE safety and soundness and mission regulator's effectiveness is enhanced by exemption from the appropriation process, allowing it flexibility to determine and structure its budget based on the primacy of safety and soundness.

The Finance Board has learned these lessons as a result of its efforts to build a stronger, more capable regulator for the Federal Home Loan Banks. We have been fortunate in that the Federal Home Loan Bank Act affords the Finance Board the prerogatives and authority required to build a truly world-class, arm's length regulator for the Banks. I believe the fast progress my Finance Board colleagues and I have made in increasing the capacity and sophistication of the agency's supervision staff demonstrates the Finance Board is well on the way to becoming just such a regulator.

Mr. Chairman, members of the committee, I respect the responsibility of the Congress to take aggressive steps to foster strong, independent regulation of both Fannie Mae and Freddie Mac and the Federal Home Loan Banks, and it goes without saying I will support whatever policy Congress adopts in this regard. Given the progress we have made at the Finance Board and the very different charters, ownership and capital structures, and business models of the Banks as compared to the other housing GSEs, however, I believe the Finance Board is achieving the goal of providing effective, efficient, and independent regulation of the Federal Home Loan Banks. Moreover, I believe it is critical that significant enhancements now underway not be lost or deferred in transition to any new regulatory regime at a time when the 12 Banks are entering a far more demanding risk-management environment.

IMPROVEMENTS IN SAFETY AND SOUNDNESS OVERSIGHT

For most of their history, the Federal Home Loan Banks were overseen by the Federal Home Loan Bank Board. That agency had a mixed mandate to help operate the Banks, to regulate the Banks' owners – federally insured thrifts – and to promote the Federal Home Loan Banks and thrifts.

Congress sorted out this puzzle with the passage of the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in 1989. Nevertheless, in a 1998 report, the General Accounting Office (GAO) found that the Federal Housing Finance Board – nine years after its creation – remained inadequately focused on safety and soundness supervision and too closely involved in operating the Banks, and at times appeared to be a cheerleader for the Banks, rather than an arm's length regulator.

Upon becoming chairman in December 2001, I quickly determined these problems still existed and had to be corrected for the Finance Board to effectively oversee the Federal Home Loan Banks and Office of Finance for safety and soundness and achievement of their housing finance mission. Just one example demonstrates this point: At the time of my appointment, the Finance Board had only eight bank examiners on staff to review and supervise a dozen financial institutions with, at the time, more than $700 billion in assets, more than $30 billion in capital, and some $650 billion in outstanding debt. Yet, at the same time, the agency also had eight people in its Office of Public Affairs. The relative allocation of resources simply did not meet the agency's statutory mandates.

In addition to being understaffed, the examination function insufficiently focused on the Banks' risk assessment processes and the Banks' internal control systems. Such shortcomings had been identified in the 1998 GAO report on the Finance Board's examination program.

These circumstances called for an immediate and vigorous response, beginning with the recruitment of new leadership for the agency's Office of Supervision. Following a national search, the Finance Board has in place a new director and a new deputy director of supervision, who between them have 40 years of regulatory experience with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC).

My Finance Board colleagues and I increased the resources available for supervision, expanding the agency's examination staff to 17 full-time bank examiners. Our goal is to have 24 in place by the end of this calendar year, and 30 by October 2004.

The Finance Board is now conducting more thorough, risk-focused examinations, and communicating the results of those examinations more effectively to the Banks.

Examinations now recognize that banking – including AAA-rated, GSE banking – is a business of managing risks, and the responsibility of bank supervisors is to ensure that the institutions they regulate understand those risks and monitor and control them through prudent risk management practices.

To enhance analysis and oversight in the risk management area, we have established two risk units – a Risk Modeling Division and a Risk Monitoring Division. The Risk Modeling Division is responsible for the development of our asset/liability modeling and for monitoring the Bank's internal interest rate risk models. The Risk Monitoring Division pulls together our data and the Banks' own financial reporting into a risk-monitoring framework.

We have hired an Associate Director for Examinations who oversees all our safety and soundness examiners. She has more than 15 years of bank regulatory experience with the FDIC. We also have hired a Senior Advisor to the Director of Supervision to provide support to the Risk Modeling and Risk Monitoring Divisions. That Senior Advisor possesses some 30 years of bank supervision, capital markets, and capital regulation experience with the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision.

While on-site examinations remain the primary tool of supervisors, the agency now complements exams with off-site monitoring and regular communication with the Banks. Our new "Bank Analyst Program" charges a member of our Office of Supervision with following an individual Bank and reviewing monthly and quarterly financial reports for trends and changes, while also keeping abreast of issues in the financial and housing industries to determine their effect on each Bank.

Our Office of General Counsel has also assigned attorneys who serve as points of contact for the examiners on issues concerning particular Banks.

In short, the Finance Board's safety and soundness oversight of the Federal Home Loan Banks has improved dramatically. We have more work ahead of us, to be sure, but the Finance Board is a much stronger and more capable regulatory agency than it was as recently as 12 months ago.

GOVERNANCE

When Congress passed the Gramm-Leach-Bliley Act of 1999, it gave the board of directors at each Federal Home Loan Bank the clear responsibility for making business decisions concerning that Bank. Any business decisions previously made by the Federal Housing Finance Board were devolved to the Banks.

This new, post-Gramm-Leach-Bliley relationship makes it even more critical that the Federal Home Loan Banks meet the highest standards of corporate governance, and that the Federal Housing Finance Board pursue rigorous safety and soundness supervision of board governance at these Banks.

Therefore, the Finance Board recently completed a thorough assessment of corporate governance at each of the Banks. This effort included the first-ever horizontal review – that is, a systemwide supervisory review of a single issue at each of the 12 Banks – which addressed the Banks' effectiveness relative to eight indicators of effective board governance.

Those indicators are:

- Engaged Board of Directors
- Skilled Senior Management
- Thorough Strategic Planning
- Sound Risk Management
- Robust Internal Control
- Effective Audit Program
- Strong Ethical Culture
- Timely, Accurate, and Complete Communications

The Finance Board's final report on this review includes a variety of general recommendations for improving corporate governance. The agency also provided specific, confidential feedback to each of the 12 Banks.

The Board's next step is to solicit from the Banks, their member institutions, experts, and interested members of the public any ideas for reform in this important area. Input generated may be used in the design of proposals aimed at making the Federal Home Loan Banks role models in corporate governance.

Earlier this year, the Finance Board also undertook a second systemwide horizontal review, that of the Federal Home Loan Banks' implementation of the statutorily mandated Affordable Housing Program (AHP). The AHP is a highly successful program that warrants a separate discussion.

THE AFFORDABLE HOUSING PROGRAM (AHP)

The Federal Home Loan Bank Act requires each Bank to establish and fund an Affordable Housing Program. Under the AHP, each Bank must annually contribute the greater of 10 percent of its net earnings for the previous year, or such prorated sums as may be required to ensure that the aggregate contribution of the Banks is at least $100 million. Actual contributions to the program were $199 million for 2002, and the contributions have exceeded $100 million each year since 1994.

AHP subsidies must be used to fund the purchase, construction, or rehabilitation of:

- Owner-occupied housing for very low-income, or low- or moderate-income (no greater than 80 percent of area median income) households; or
- Rental housing in which at least 20 percent of the units will be occupied by and affordable for very low-income (no greater than 50 percent of area median income) households.

In 2002, the Finance Board adopted a regulation enabling Banks to allocate annually the greater of $4.5 million or 35 percent of each Bank's AHP contribution to homeownership set-asides. Part of this increased funding authority helps Banks combine AHP subsidies with HUD initiatives benefiting minority, immigrant, and other first-time homebuyer families.

Since the inception of the AHP in 1990, the Federal Home Loan Banks have contributed $1.7 billion to the program, funding 236,596 rental units and 122,126 owner-occupied units. In 2002, the Banks committed $286 million to AHP projects.

The Finance Board appropriately devolved operation of the AHP program to the individual Banks in the late 1990s, a valuable development because the Banks are best equipped to assess local affordable housing needs and build partnerships with local community groups and housing agencies.

Correspondingly, the Finance Board's oversight responsibility has grown with respect to the AHP to ensure proper and effective program operation. As such, we are following up the horizontal review with a new practice of examining each Bank's AHP program once a year. These exams are performed by examiners and analysts whose specialized training has specifically equipped them for this task.

We are also preparing regulatory language intended to enhance the effectiveness of the AHP by permitting Banks more latitude in establishing the criteria to score applications. The goal is for Banks to be more responsive to local housing conditions. We also plan to streamline the application process to permit projects to proceed more quickly and with lower administrative costs for the Banks.

AHP is truly one of the Federal Home Loan Banks' great success stories, and with rigorous oversight at the Federal Housing Finance Board, I am confident it will be even more successful in the years ahead.

REGULATORY PHILOSOPHY AND APPROACH

The 1998 GAO report also faulted the Federal Housing Finance Board for failing to maintain an arm's length relationship from the Federal Home Loan Banks, and my Finance Board colleagues and I have undertaken a range of steps to rectify this inappropriate approach toward regulation.

Two unanimous votes by the Finance Board – one a year ago, one just this month – demonstrate the new, more professional relationship between the regulator, the Finance Board, and the regulated entities, the Federal Home Loan Banks.

The Finance Board's current practices now recognize that its proper role is not to operate the Federal Home Loan Banks, not to cheerlead for them, but rather to function as a true arm's length regulator.

In September of 2002, the Finance Board adopted standards of conduct that delineated the formal relationship it now maintains with respect to the Federal Home Loan Banks. The standards also reaffirmed rules prohibiting Federal Housing Finance Board directors or employees from accepting meals, travel, or gifts from Federal Home Loan Banks.

By adopting these standards the Finance Board drew what I call "the bright red line of separation" between the regulator and regulated entities, a separation Congress sought to establish with passage of the Gramm-Leach-Bliley Act. The relationship means the Finance Board will act, at times, in the face of disagreement with the Federal Home Loan Banks.

An example of this independence is the other, more recent unanimous vote I mentioned. On September 10, the Finance Board adopted a proposed rule to require each Federal Home Loan Bank to register a class of its securities with the Securities and Exchange Commission under the Securities Exchange Act of 1934. While not all Banks embrace voluntary registration with the SEC, the Finance Board determined enhanced Bank disclosure – with appropriate safeguards to ensure continued effective operations of the Banks – is in the best interest of, in this case, investors in the Bank System and, more broadly, the public who stand behind these GSEs.

ENHANCED DISCLOSURES

In July of 2002, the Administration called on all government sponsored enterprises to comply with the corporate disclosure requirements of the Securities Exchange Act of 1934, as interpreted and enforced by the SEC.

Fannie Mae and Freddie Mac, the other two housing-related GSEs, answered this call. Fannie Mae has already filed its first disclosures under the new SEC regime.

As Chairman of the Federal Housing Finance Board, I, too, am determined to hold the Federal Home Loan Banks to the highest standard of disclosure. Accordingly, I formed a working group from the Finance Board and the Federal Home Loan Banks to review the implications of acceding to the Administration's request that all GSEs register.

Early this year, I concluded that voluntary registration with the SEC was indeed the best approach to providing enhanced public disclosure of the governance and finances of the Federal Home Loan Banks. I reached this conclusion based on two premises.

First, the Banks' long-term access to global capital markets will be enhanced by providing investors in consolidated obligations with maximum reliable transparency into the finances and governance of each of the 12 Banks. Markets function best, especially in times of stress, when needed information is readily available and reliable.

Second, as public trusts, these 12 GSEs have a duty to contribute both to the smooth functioning of capital and mortgage finance markets and to public confidence that the benefits of GSE status are used wisely.

At my urging, Federal Home Loan Banks and the staff of the SEC have held numerous meetings to address the process for voluntary registration, including methods for resolving several key disclosure and accounting questions.

The Board of Directors of the Federal Home Loan Bank of Cincinnati actively embraced the disclosure initiative as in the best interest of its members, voting in February to pursue voluntary registration. Last month, the Cincinnati board resolved to "actively engage, effective immediately, in the process of voluntary registration with the SEC of its member-held stock."

This summer, too, the boards of the Federal Home Loan Bank of San Francisco and the Federal Home Loan Bank of Atlanta resolved that, if SEC registration was the determined course of action, it is their request that the Finance Board adopt a regulation requiring it.

In response to those requests, on September 10 the Finance Board unanimously adopted a proposed regulation requiring each Bank to register a class of securities with the SEC under section 12(g) of the Securities Exchange Act of 1934.

The proposed rule provides for a lengthy, 120-day comment period, during which, I hope, the Banks will each meet with the SEC to work out the necessary details to effectuate registration and begin meeting the periodic financial reporting requirements of the '34 Act.

Following the Finance Board's recent vote, two additional Banks – New York and Topeka – also adopted resolutions moving them toward voluntary registration.

The focus of the enhanced disclosure effort from the start has been to ensure that the Federal Home Loan Banks play their part, as government sponsored enterprises, in contributing to the smooth functioning of the capital and mortgage finance markets. In the end, consistent and full disclosures of these institutions' finances and corporate governance also serve the public, who stand behind their charters as government sponsored enterprises.

CONCLUSION

Mr. Chairman, distinguished members of the Committee, thank you for allowing me to discuss with you today the Federal Housing Finance Board and its efforts to strengthen the agency's ability to oversee the Federal Home Loan Banks for safety and soundness and accomplishment of their housing finance mission. Since 2002, the Finance Board has dramatically improved its ability to perform its statutorily mandated responsibilities. The agency's supervision function is stronger, more thorough, and more effective. Taken in conjunction with the initiative to enhance the financial disclosures provided by the Federal Home Loan Banks, I believe the Finance Board is capably representing the interests of the public and taxpayers who stand behind the Federal Home Loan Banks and who benefit from the successful performance of the Federal Home Loan Banks' important role in housing finance.

I hope the experience of the Finance Board during this process will be of value to this Committee as you consider H.R. 2575 and other issues relating to government sponsored enterprises.

I am pleased to respond to any questions.