OVERSIGHT OF THE FEDERAL HOME LOAN BANK SYSTEM

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

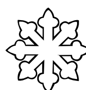
ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

OCTOBER 12, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–71



U.S. GOVERNMENT PRINTING OFFICE

72–612 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
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OVERSIGHT OF THE FEDERAL HOME LOAN BANK SYSTEM

Wednesday, October 12, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1:02 p.m., in room 2220, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Fitzpatrick, Pearce, Posey, Hayworth, Canseco, Fincher; Capuano and Waters.

Also present: Representatives Garrett and Grimm.

Chairman NEUGEBAUER. We are waiting on a couple of Members and we will get started here shortly. BlackBerrys are down in the Capital. It has locked the whole city down.

This hearing of the Oversight and Investigations Subcommittee of the Financial Services Committee will come to order.

Today's hearing is on oversight of the Federal Home Loan Bank System. Without objection, I ask unanimous consent to allow Mr. Garrett, who is not a member of this subcommittee but is a member of the full Financial Services Committee as well as the chairman of the Capital Markets Subcommittee, to join us.

Without objection, it is so ordered.

Someone asked why we are having an oversight hearing on the Federal Home Loan Bank System? Well, for a couple of reasons.

One reason is that we haven't had one in 5½ years. Lately, we have been waiting until there is a crisis and then we have oversight hearings. And a lot of people think maybe this is not the time to be doing oversight, but maybe you ought to do oversight in front of issues instead of in a trailing manner.

And the other reason is that the Federal Home Loan Bank System is a trillion dollar entity. It has a huge impact on liquidity in the marketplace, and has served a function in housing and other areas by providing liquidity for banks.

So it is an important piece of our financial System and obviously it is an opportune time to have a little bit of an update. I think one of the things that obviously there has been a lot of discussion about GSEs. And the Federal Home Loan Banks are, in fact, GSEs.

So one of the issues that I think we will want to hear more about today is that really the core mission of the Federal Home Loan Bank System in the past was to provide advances, as they are called, to their member banks.

But when we started looking at the balance sheets of some of these entities, we found out that a lot of them, in fact, hold more investments and things other than advances, other than they do in advances.

So the question is, has the Federal Home Loan Bank System gotten away from their core mission statement? And one of the things—not to draw an analogy here but to go back and revisit Freddie Mac and Fannie Mae, a lot of people feel that where Freddie and Fannie went wrong was that they got away from their core mission and tried to be some things that maybe they shouldn't have tried to be.

Obviously, we want to talk today about what is the core mission of the Home Loan Banks, and are they following that mission. And I think the other question is, is that System operating in an optimum way? Because obviously the efficiency of the System has a huge impact on the cost of capital to the members, and so, obviously that is an important thing, particularly in this environment.

I think that this is an excellent opportunity for a couple of things: one, for our distinguished committee members to learn a little bit more about the Federal Home Loan Bank System, and for us to get an update; and to get into some discussions about what is the direction forward for the banks as well.

So I appreciate our distinguished witnesses today, and we look forward to some healthy discussion here.

With that, it is a great segue to turn it over to Ranking Member Capuano for his opening statement.

Mr. CAPUANO. Ditto. I am looking forward to hearing from you guys.

Chairman NEUGEBAUER. And I would now recognize Dr. Hayworth for 1 minute.

Dr. HAYWORTH. Thank you, Mr. Chairman.

And it is particularly important, I think, sir, that we think about the role and the future of the Federal Home Loan Banks—and it is so appropriate that Chairman Garrett is here—because as we consider the role of the GSEs and how we can mitigate the potential negative effects that unfortunately the expansion of the GSE's mission statement beyond what they were able to do.

As we consider how we backed the GSEs out of their undue influence on the economy, what role would the Federal Home Loan Banks play? And how can we make sure that our community banks, who are focused on their customers, their clients, and their communities—how can we make sure that we are helping them and not hurting them to perform a crucial role? So I look very much forward to what our panelists have to say.

And I want to thank you again, sir, for holding this hearing.

Chairman NEUGEBAUER. I thank the gentlelady.

And now, Mr. Fitzpatrick is recognized for 2 minutes.

Mr. FITZPATRICK. I would like to thank the chairman, Mr. Neugebauer, for holding this oversight hearing today to discuss and examine a number of issues surrounding the Federal Home Loan Bank System.

I would also like to welcome a fellow Pennsylvanian, Tim Zimmerman, appearing here today on behalf of ICBA. Tim not only serves as chairman of the ICBA Bank Task Force, but also as

chairman of the Legislative Committee of the Pennsylvania Community Bankers.

So thank you for your service.

The Federal Home Loan Banks could well be called the quiet GSE. They are typically in the background meeting their primary statutory mission of providing liquidity to member banks across the Nation.

Just because they are quiet does not mean that they are not important. I hear from bankers all the time throughout my district about the importance of the Federal Home Loan Banks.

As we see from our witnesses' testimony today, community bankers often use the Home Loan Bank loans to structure their loans in markets to meet credit needs. Local bankers safely making loans to their customers certainly is central to building a strong economy.

I also hear from leaders in the area of affordable housing in my district about how important the affordable housing program is. It is not just the downwards, but the bringing together of the various local governments, community bankers, the affordable housing program individuals, and the nonprofits that is important, not just in my district in Pennsylvania, but in districts throughout the Nation.

So as we move forward on GSE reform and devise a new mortgage finance System in this country, good actors should not be lumped in with bad ones. We must be deliberate in our actions to ensure our constituents that they have access to capital.

And as we have seen with Dodd-Frank, all too often the unintended consequences of Washington's actions represent backwards steps, unfortunately not always forward steps.

Clearly, our community banks have a vital partnership with the Federal Home Loan Banks. And we all need more investments in our districts.

So this hearing will help us to gather information to form an understanding of how we protect taxpayers, while ensuring that the banks contribute to our economic recovery.

I look forward to the testimony here today, and I thank the chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Texas, Mr. Canseco, for 1 minute.

Mr. CANSECO. Thank you, Chairman Neugebauer, and thank you for calling this very important meeting.

After learning the hard way about Government-Sponsored Enterprises 3 years ago, no stone that enjoys an implicit backing by the Federal Government should be left unturned by the Congress.

Federal Home Loan Banks play a sizeable role in our financial economy with assets of over $800 billion as of June.

And many financial institutions, particularly community banks, have come to rely on funding from the Home Loan Banks, as was highlighted during the financial crisis of 2008.

With the Home Loan Banks having such a significant role in our financial sector, Congress must examine closely the operations of these institutions to ensure that they are functioning safely and soundly, and not putting the financial sector, or especially the taxpayer, at risk.

I look forward to hearing from our witnesses today on this very important matter.

Thank you, Mr. Chairman, and I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Garrett is recognized for 1 minute.

Mr. GARRETT. I also thank the chairman for holding this very important meeting, and ditto as well.

I recognize the very important role that the Federal Home Loan Bank System has played in the past, and currently plays in the Nation's housing and finance System, basically providing access to capital markets, especially to many of our local banks.

And while they perform their core mission, providing advances as well, I think, during the financial crisis, I still believe there is always room for review and improvement.

After the collapse of Fannie and Freddie, there was widespread agreement, I think, on both sides of the aisle that it is really inappropriate to have American taxpayers implicitly back the institutions and their debts. The consensus view, I think, is that government guarantees should either be on the books, transparent, and budgeted for or they shouldn't exist at all.

So I think the recent credit downgrade of the U.S. Government by S&P, followed by the downgrade then right after of Federal Home Loan Banks, is something of a signal of the market's perception of whether or not the Federal Home Loan Bank is either explicitly backed by the taxpayer or not.

So it just raises a number of questions, I think, that we have to look at. There is not going to be an easy answer to this, but it is essential that we have that discussion.

And I thank the chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And I believe that is everybody.

I would remind all Members that your opening statements will be made a part of the record.

I am now going to introduce our witness list, and I am going to yield back to the gentlewoman from New York to introduce Mr. Costa.

Dr. HAYWORTH. Thank you, Mr. Chairman.

Mr. Anthony Costa has over 44 years of distinguished community banking service in the mid-Hudson Valley. His B.S. degree is in accounting.

And since July of 2004, he has been chairman and CEO of Empire State Bank, which was organized and opened in July of 2004. It is now a $160 million company serving the mid-Hudson and Staten Island areas.

Mr. Costa has also held executive positions at First Interbank Corp as president and chief operating officer from 1990 to 1994, and at Mid-Hudson Savings Bank, which is a wholly-owned subsidiary of First Interbank Corp.

He was president and CEO of Intercounty Savings Bank from 1970 until 1990 when Intercounty and Mid-Hudson Savings Bank merged together under the First Interbank Corp logo.

He has also served—or is currently serving on the boards of directors and/or committees for a number of community-related and professional organizations including the Mid-Hudson Family Health Institute, the People for People Fund, the Institute for Family Health in New York City, the New York Banker's Association,

the Benedictine Hospital, the American Bankers' Association, and the Bishop Dunn Memorial School.

Thank you so much, Mr. Costa, for being with us today.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentlewoman.

We also have: Mr. Lee Gibson, chairman of the Federal Home Loan Bank of Dallas, and chairman of the Council of Federal Home Loan Banks; Mr. Tim Zimmerman, president and chief executive officer of Standard Bank of Pennsylvania, on behalf of the Independent Community Bankers of America; and the Honorable Bruce Morrison, former Member of Congress, and former Director of the Federal Housing Finance Board.

I remind each of you that your written statements will be made a part of the record, and you will be recognized for 5 minutes to summarize your testimony.

And with that, I will recognize Mr. Costa.

STATEMENT OF ANTHONY P. COSTA, CHAIRMAN AND CO-CHIEF EXECUTIVE OFFICER, EMPIRE STATE BANK, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION (ABA)

Mr. COSTA. Thank you, Chairman Neugebauer and Ranking Member Capuano.

My name is Anthony Costa, and I am chairman and CEO of Empire State Bank, which is a $165 million asset community bank in New York's Hudson Valley.

I also served as chairman of the Federal Home Loan Bank Committee at the American Bankers Association. And I thank you for the opportunity to testify today.

The Federal Home Loan Bank System plays a vital role in mortgage financing and economic development in communities throughout the United States. And its importance cannot be overstated. Many of our loans at Empire State Bank could not have been made were it not for our Federal Home Loan Bank.

Congress and the regulators will soon consider changes to the secondary mortgage market and to Fannie Mae and Freddie Mac. It is critically important that any reform of the secondary mortgage market protect the traditional business of the Federal Home Loan Banks and access to liquidity by their members.

Failure to do so will have a detrimental effect on mortgage funding and homeownership for many years to come.

During the recent financial crisis, the Federal Home Loan Banks played a critical role for bank members. As the crisis took hold and credit markets froze, the Federal Home Loan Banks were the first available source of funding for banks like mine at a time when it was most needed. It allowed us to continue to serve our communities even in the face of extreme difficulties.

As members had more need for liquidity, Federal Home Loan Banks increased advances from $650 billion at the beginning of the crisis, to over $1 trillion at its peak. The demand for liquidity has diminished, and now advances are below pre-crisis levels.

This proves the flexibility of the System and demonstrates its ability to withstand crisis. In 8 decades and through numerous financial crises, the Federal Home Loan Banks have never incurred a credit loss on an advance.

The Federal Home Loan Bank System does more than just liquidity management. It also runs two important programs that provide housing and economic development for low- and moderate-income communities: the Affordable Housing Program; and the Community Investment Program.

The Affordable Housing Program is one of the largest private sources of funds for affordable housing in the United States. Through this program, banks can fund projects that otherwise might never be carried out.

These projects serve a wide range of community needs. Many are designed for seniors, the disabled, homeless families, first-time homeowners, and others with limited resources. More than 726,000 housing units have been built using the Affordable Housing Program funds, including 457,000 units for very low-income residents.

The Community Investment Program offers below-market-rate loans to banks like mine for long-term financing to low- and moderate-income families. The program is a catalyst for economic development because it supports projects that create and preserve jobs, and helps build infrastructure to support growth.

Banks like mine have used the Community Investment Program to fund owner-occupied and rental housing, construct roads, bridges and sewer treatment plants, and to provide small business loans. The program is especially appreciated in rural areas where resources are limited.

Since 1990, the Community Investment Program has lent over $61 billion for a variety of projects, resulting in an estimated 200,000 jobs.

Recently, the Administration and regulators have proposed ill-advised membership and benefit changes that would make it more difficult for all financial institutions to access the funding available through the Federal Home Loan Banks. The changes would devalue membership for existing Federal Home Loan Bank members and discourage potential members from joining.

These proposals, if adopted, would have a deeply negative impact on the ability of Federal Home Loan Banks to carry out important programs like the Affordable Housing Program and the Community Investment program. They should be rejected.

In conclusion, the Federal Home Loan Bank System is strong because of the diversity of its membership. Without the Federal Home Loan Banks, community banks would not be able to reliably meet demand and there would be less funding available to improve low- and moderate-income communities.

As Congress considers reforms of the mortgage markets, it is crucial that the important role of the Federal Home Loan Bank System be preserved. I would be happy to answer any questions.

[The prepared statement of Mr. Costa can be found on page 42 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Costa.

Mr. Gibson?

STATEMENT OF LEE R. GIBSON, CHAIRMAN, FEDERAL HOME LOAN BANK OF DALLAS, AND CHAIRMAN, COUNCIL OF FEDERAL HOME LOAN BANKS

Mr. GIBSON. Good afternoon, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee.

My name is Lee Gibson, and I am chairman of the Council of Federal Home Loan Banks, as well as chairman of the Federal Home Loan Bank of Dallas. I am also the chief financial officer of Southside Bank, a $3 billion community bank with headquarters in Tyler, Texas.

Mr. Chairman, I would like in the time I have today to describe why the Federal Home Loan Banks are essential to the future of not only my community bank, but to all community banks across the country.

Federal Home Loan Banks are cooperatives. We are 100 percent owned by our members, comprised of nearly 7,800 financial institutions. By design, our capital structure does not subject us to the growth and income pressures that publicly-traded corporations face.

Community financial institutions rely on us as a source of funding for financing housing, jobs, and economic growth in their communities. Both large and small lenders are likely funding lending in your community with the help of their Federal Home Loan Bank.

We have been around for over 80 years, in good times and bad. Through the Nation's most recent financial turmoil, the Federal Home Loan Banks passed this significant stress test and once again proved to be a model that works. When the crisis unfolded and other funding sources disappeared, we were the only source of liquidity available for many of our members.

We owe our stability and long record of successfully fulfilling our mission to our unique business model and cooperative structure. Our core business is issuing what we call advances. We borrow funds from all over the world and provide those funds to our members in the form of fully-secured loans.

For the vast majority of our members, these advances are the only access they have to the global credit markets. Federal Home Loan Bank advances lower the cost of extending credit to Americans.

They are the primary way that the Federal Home Loan Banks serve as a mechanism for economic stability in America. All advances are secured by eligible collateral and the purchase of capital stock. Members must meet strict collateral, capital, and credit standards that are continually monitored.

Our cooperative structure also demands that we focus intently on capital. In fact, we recently voluntarily entered into a joint capital enhancement agreement to further strengthen the System. Each Home Loan Bank will now, on a quarterly basis, allocate 20 percent of its net income to a separate, restricted retained earnings account.

Our commitment to affordable housing and community development is both proven and strong. Working with our members, we have helped more than 2 million American families in the last 20

years, through more than $61 billion in long-term financing, and nearly $4.5 billion in direct grants.

Each Home Loan Bank is regionally focused and controlled, allowing it to be responsive to the specific credit needs of the communities that its members serve.

It is a System that functions well. That is why the Administration's February report to Congress, which included several proposed changes to our unique structure, concerns me greatly. I believe these proposals would disassemble the model that American communities and their local lenders have relied upon for years.

Mr. Chairman, I want to speak to the committee for a moment as a community banker. In a time when so many of our institutions are in need of repair, we have a community banking System in America that works.

It works because as local lenders, we know our communities expect us to do business in a responsible way, and to remain focused on the needs of our own communities. Our community banking System also works because it can rely on a critical partner, the Federal Home Loan Banks.

America's Federal Home Loan Banks may be invisible to the community banker's customers, but the Federal Home Loan Banks are there for our customers every day.

I urge you in considering the Federal Home Loan Banks to preserve and protect their proven value to the Nation's community banking System and the Americans we serve.

Mr. Chairman and members of the committee, the Federal Home Loan Banks are a model that works. It is a structure that must not be changed.

Thank you, Mr. Chairman, for the opportunity to speak to you today, and I look forward to taking any questions the subcommittee may have.

[The prepared statement of Mr. Gibson can be found on page 50 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Gibson.

Mr. Zimmerman?

STATEMENT OF TIMOTHY K. ZIMMERMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, STANDARD BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. ZIMMERMAN. Good afternoon, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee.

My name is Tim Zimmerman, and I am president and CEO of Standard Bank, a $435 million sized community bank headquartered in Monroeville, Pennsylvania. Standard Bank is a member of the Federal Home Loan Bank of Pittsburgh.

I also serve as chairman of ICBA's Federal Home Loan Bank Task Force. I am pleased to represent ICBA's nearly 5,000 members today at today's hearing about the Federal Home Loan Bank System.

I welcome this opportunity to share Standard Bank's experience with the Federal Home Loan Bank of Pittsburgh, which is broadly typical of community banks nationwide.

The 12 regional Federal Home Loan Banks are a critical resource to community banks, the vast majority of which are members of the Federal Home Loan Bank System. Federal Home Loan Banks help community banks like mine better serve our communities and compete with too-big-to-fail institutions in our markets.

They demonstrated their value during the recent financial crisis when they continued to provide liquidity through advances after other parts of the credit markets shut down. As Congress debates the future of the housing finance System, I urge you to preserve the role of the Federal Home Loan Banks.

Community banks value Federal Home Loan Bank membership primarily for the access to advances they offer. Standard Bank, for example, currently holds $33 million in advances, an amount that has recently fluctuated widely with economic conditions.

Federal Home Loan Banks offer advances in a variety of maturities and customized terms for their members. These advances are made possible by the Federal Home Loan Banks' strong credit rating and access to the world credit markets, access that is not practical for a community bank.

Community banks use advances to fund mortgages and other types of loans to manage the substantial interest rate risk associated with holding longer-term fixed-rate loans in portfolio. Some community banks use advances to adjust the duration of their liabilities to better match their assets and manage risks.

Additionally, short-term, on-demand advances can be used to provide liquidity and manage cash flow. Most community banks qualify as community financial institutions, and are therefore able to collateralize advances with small business and agricultural loans in addition to residential mortgages.

The broader mission of the Federal Home Loan Bank distinguishes them from Fannie Mae and Freddie Mac, which are focused exclusively on residential mortgage lending.

Many rural bank members of the ICBA report that the Federal Home Loan Bank advances are absolutely essential for their ability to remain competitive in agricultural lending, in particular, long-term fixed-rate loans of 10 years or more would be nearly impossible for a community bank to make without the use of Federal Home Loan Bank advances. These loans cannot be funded with short-term deposits because of interest rate risk.

Federal Home Loan Bank advances help bankers meet the cyclical challenges inherent in agricultural lending and play a critical role in helping the rural economy to prosper and remain vibrant. Agricultural lenders use advances to fund their short-term agricultural production loans. During peak season demands, as much as 50 percent of such lending is supported by advances.

ICBA strongly opposes the current Federal Housing Finance Agency proposal that would re-impose a mortgage lending test on Federal Home Loan Bank members. The Gramm-Leach-Bliley Act lifted the mortgage asset test for community financial institutions, which is significant for rural lenders that have few residential lending opportunities that greatly benefit from Federal Home Loan Bank membership.

In addition to advances, Federal Home Loan Banks offer a range of other valued services including community investment programs

and correspondent programs. The mortgage partnership finance program of secondary market options for members is especially important to Standard Bank.

We sell all of our fixed-rate loans with a term of more than 15 years to the Federal Home Loan Bank of Pittsburgh to avoid interest rate risk exposure. Without this option, we would not be able to make the long-term fixed-rate loans our customers expect, and we would not be able to compete with large banks.

While many community banks continue to sell primarily to Fannie Mae and Freddie Mac, the MPF programs of the various Federal Home Loan Banks are an important alternative source of secondary market access.

As Congress and the Administration consider changes to the housing finance System, we urge you to preserve the significant role of the Federal Home Loan Banks, which help community banks serve the mortgage, small business, and agricultural lending needs of their communities, and remain competitive with the large banks and tax advantage farm credit System.

There is no reason to tamper with the model that has worked well since inception, and proved its critical value during the recent crisis. The Federal Home Loan Banks must be kept distinct from Fannie Mae and Freddie Mac.

ICBA opposes proposals to merge them.

While community banks have benefited from existing Federal Home Loan Bank secondary market programs, the primary business of Federal home banks must remain advances.

Thank you again for convening this important hearing.

We appreciate the opportunity to discuss the Federal Home Loan Banks, and how important they are to community banks. And I am also very happy to answer any questions.

[The prepared statement of Mr. Zimmerman can be found on page 77 of the appendix.]

Chairman NEUGEBAUER. Thank you.

Mr. Morrison?

STATEMENT OF THE HONORABLE BRUCE A. MORRISON, FORMER MEMBER OF CONGRESS, FORMER DIRECTOR OF THE FEDERAL HOUSING FINANCE BOARD, AND CHAIRMAN, MORRISON PUBLIC AFFAIRS GROUP

Mr. MORRISON. Thank you, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee. It is an honor and a pleasure to be here, and I thank you for inviting me.

I am here to express personal views based on experiences that I have had with the Federal Home Loan Bank System. And I am very happy to answer any questions that Members may have.

In my written testimony, I covered a number of different topics related to the System. I will focus on a few of these in my oral testimony.

“Liquidity” is one of those words we use all the time. We don’t really notice its value until it is gone. Lehman Brothers is a wonderful example of what happens when liquidity fails and you get markets that don’t work.

The banks have provided liquidity to members in all kinds of markets. They were set up to be a liquidity source for S&Ls in 1932. This is a Herbert Hoover program.

You don't hear many of those being discussed. But it has been a success ever since.

It was the first intervention by the government in facilitating housing lending, and it has been a success in that regard for all of its 80 years.

It certainly was tested on that score during the recent financial crisis, and it responded admirably.

There were some questions raised on the Hill about its work, about all the money that flowed out. But the fact is that it flowed out, and it also flowed back, because of the very favorable security position that the banks have.

So from that perspective, the banks can be very proud of their performance.

It has a co-op structure. That is extremely important. One of the things that happened in Fannie and Freddie was the conflict between investors, who cared only about profits, and a public mission that the taxpayers were standing behind.

That conflict is absent in the bank System; its members are competitors. So whatever benefit they get from Federal backing, in terms of cost of funds, tends to pass through to customers because of competition.

That is a good thing. And that is a useful structure to understand.

The bank System has more than just just community bank members. Everyone who talks about the bank System talks about the value to community banks. And I think that value is indisputable.

I think the liquidity that is provided for longer-term assets for community banks, going back to the S&Ls of the 1930s, is one of its proudest achievements.

The fact is, however, when you look at its balance sheet, and ask who got the advances, you will find a very high percentage of them went to very large financial institutions.

And the question is—where does that fit? Is it something that should exist? Should it be in any way restricted? Should it be in any way targeted?

I have some thoughts about that. But let me first say that one of the things that reflects the success of the banks is their performance in the affordable housing program. But it is also a very small program.

It is $150 million to $200 million a year. This is an $800 billion to $1 trillion System. That is a small amount of money compared to the size of the System.

But the money has been used very well, and has been targeted in two areas: investment in low-income, multi-family housing developments; and in downpayment matching programs for single family purchases by low- and moderate-income people. Both of those have been great successes.

I regret the fact that the completion of the Refcorp payments did not lead to an increase in investment in the affordable housing program because, frankly, it is one of the jewels of the System.

I would also comment that I was a member of this committee when this program was created in 1989, and the banks were all against it.

The fact is that it was forced on them. But I don't think there is a single bank that would give it up today, so sometimes Congress is ahead of the crowd—maybe not usually.

As I mentioned, the banks' performance in response to the crisis was admirable.

But there are fiscal pressures on the banks. These are fiscal pressures from the amount of capital that they hold, the dividends they seek to pay, and the low yield that is represented by advances.

That fiscal pressure does get them into other kinds of assets. And their private mortgage-backed security holdings have gotten them into trouble, and have cost them.

It wasn't their fault that the triple-A ratings didn't mean triple-A. They aren't the ones that mis-rated these assets. But the temptation to bulk up on profitable assets is not independent of the structure that exists. And it deserves discussion.

Finally, with respect to the future, there is the implied guarantee—Congressman Garrett referred to it. But the implied guarantee, in my opinion, is something we shouldn't have.

If we are going to have a government guarantee, it should be paid for up front, and it should be regulated up front. Implied guarantees mean if things go bad, taxpayers write a check. And there is nothing against which to draw.

I think that is a mistake. And I think that you asked the question, going forward, how will this work?

Will there be explicit guarantees for Federal Home Loan Bank debt?

You can get rid of debt for Fannie and Freddie. You don't really need to have portfolios.

But advances are assets. And you have to have liabilities to fund them. So the debt question and implied guarantee is right in front of you in the Federal Home Loan Banks.

Finally, big and small, how much should the System be available to very large holding companies?

My view is that there is a value to their participation, a financial value. But if they are going to participate, their advances should be limited to backing those kinds of assets that could not otherwise be supported, like whole loans for housing, and perhaps certain kinds of economic development loans, rather than general liquidity. And we are at the general liquidity end of the spectrum right now.

Thanks for the opportunity to comment on these matters, and I look forward to your questions.

[The prepared statement of Mr. Morrison can be found on page 68 of the appendix.]

Chairman NEUGEBAUER. I thank the panel, and will now recognize members for 5 minutes for questions, starting with myself.

Mr. Gibson, I think in your written testimony, you mentioned advances represent the core of the Federal Home Loan Bank business.

I want to quote you something that FHFA Acting Director DeMarco recently said.

He says advances at 52.4 percent of assets barely exceed half of the System's combined assets. At six Federal Home Loan Banks, investments exceed 40 percent of assets. At four of these Federal Home Loan Banks, investments exceed advances.

He says this is not a sustainable operating condition at the Federal Home Loan Banks. It appears we look through that, that these entities have changed their business model from being an advance business to also being an investment business.

Someone used the term—are we turning our Federal Home Loan Bank into hedge funds?

So what is the correct—have the banks strayed from their core mission? And as I think was pointed out by Mr. Morrison in his public record, a number of the banks in the System got into the mortgage-backed security business. And it was painful.

Had they not been in that business, would they be healthier banks today?

Can you give me your impression on what is the appropriate amount of investment activity for a bank? And why do they need to be in the investment business?

Mr. GIBSON. Yes, sir. I would be glad to answer that.

Basically, it goes to the scalability of the System. As I think it was mentioned, advances grew from roughly $640 billion second quarter, end of second quarter 2007, to a little over $1 trillion, the third quarter ended 2008.

With that, additional capital came into the System. Advances were extremely high at that point in time, and there were some additional investments that were bought because we have certain investment limits.

We are limited on tax and investments we can buy. We are also limited on percentages of investments that we can buy.

Now, we are down to $428 million in advances at the end of second quarter 2011. And due to the scalability, a lot of those investments have not rolled off at this point in time.

If we stay at that $428 million, the level of investments is going to shrink. And we are going to see a more sustainable percentage of investments to advances.

But the investments also act to help us in a number of ways. It helps us with that scalability issue from the standpoint that it provides us additional earnings.

For instance, right now, we only have $428 billion in advances. It provides us additional earnings so that we can keep in place a structure that we need at the banks, risk managers, auditors, things of that nature, so that if we needed to scale back up in the next 5 quarters to over $1 trillion, we need to make sure we have those things in place.

So it acts and it is a buffer. But it also goes to the scalability. And right now, yes, we have shrunk and we do have additional investments. It is something that will roll off over time.

Chairman NEUGEBAUER. Along with that scalability, and I have heard, I think, several of the panel use that term, the question is, and there has been some discussion about this, do we need 12 Federal Home Loan Banks to do the function? And would there be some scale achieved by some consolidation to fewer banks rather than keeping that infrastructure in place for 12 regional banks?

Mr. Zimmerman, you look like you want to jump in on that one.

Mr. ZIMMERMAN. I can jump in on that one.

I think my answer to your direct question would be that I believe there is a strong argument that there should be 12, or at least more than one Federal Home Loan Bank.

Clearly, if you are only talking about whether it is less expensive to have one super structure, the answer is yes.

But it is the same reason I have more than one office. Whether I have 10 offices in my bank, and we can serve the communities that we are in better by having people closer to the community, understanding those communities, and familiar with the customers and things like that.

And I think the same thing goes for the Federal Home Loan Banks for a couple of reasons. First, for the same idea that the Federal Home Loan Bank of Des Moines has a different customer base, and they have different needs than the Federal Home Loan Bank in Atlanta does, for example.

And so there is a better understanding in those banks. And they can serve their constituency better.

Also, because of having the regional structure, as the economy changes and there is a particular problem in one part of the economy like we have seen, not in this latest crisis, but in the oil patch days, which I am sure you are familiar with, it works to help sustain the System.

And as you know, the Federal Home Loan Banks are all jointly and separately liable, so it kind of works together to help balance all that out. So I really strongly believe that we are much better with a structure that has a regional base. And 12 may not be the absolutely perfect number, but I am very sure that one isn't the right answer.

Chairman NEUGEBAUER. Thank you, and now the ranking member, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Gentlemen, thank you.

I think the Home Loan Banks do an excellent job overall. And I just want to say thank you on behalf of my constituents and myself for what you have done.

I do have a couple of questions. I want to start with the last one, the advances that are made.

I understand why you went up. I have to be honest. I am not sure why you have cut it 30 percent below what you were before the problem.

I say that because the truth is for me, I am trying to find any way I can to encourage anybody and everybody to get off the bench and get our economy moving again.

And the Federal Home Loan Bank, in my opinion is a key player there. You are not the only one, but you are a key player.

And you are talking $212 billion less than you had out in the market before the problem. Now, I understand the problem.

But from what I have seen, you have survived the problem probably better than anybody. And therefore, how do I get you to get it moving again?

I need you to get that money back out to your local banks so they can get it out to homeowners, and small businesses, and everybody else to help get this economy moving.

What do we have to do to beg?

Mr. GIBSON. I would be glad to take that question.

Right now, I know as a community banker in Tyler, we are overrun with deposits. And it is not a situation that we were having back in 2007.

Right now, American citizens are looking for asset classes to put their money in, and they are not finding asset classes they are satisfied with. So they are sticking the money in the banks. And the banks are growing in deposits by leaps and bounds.

I happen to be very fortunate to be in a part of the country that hasn't suffered quite as much as many of the other parts of the country. But I can tell you that people are a little leery of going out and expanding business at this point in time with all of the uncertainty that is out there.

And so we are—

Mr. CAPUANO. At the same time, I won't speak for my colleagues but I have heard it from numerous Members of Congress, including myself, I hear it all the time, particularly from small businesses, that they can't get access to the capital that they need.

And there is some disconnect here. If you have the money to lend, and I have people who want to borrow it, how do I make a marriage?

Mr. GIBSON. I know at our bank, we would love to make loans. That is what we want to do.

Mr. CAPUANO. Come to Boston.

Mr. GIBSON. Come to Boston, okay.

Mr. CAPUANO. We will open up a branch. We will get you going—

Mr. GIBSON. The issue is we don't know how to do banking in Boston. And we are not familiar with the area. And that is why—

Mr. CAPUANO. We will teach you—

Mr. GIBSON. —the community banks in Boston, I think, are probably better suited to make those loans than a bank in Tyler, Texas, because we stick to our knitting in East Texas, and know that market.

We don't know the Boston market.

But, to your point, we are flush with cash right now. We are not trying to run depositors away, but gosh we are paying nearly zero on the money, and they are still bringing it in.

We can't loan it out fast enough. And the demand is just not there. We can't force our customers to borrow money.

And so the Home Loan Bank by default is ending up in a situation where the banks need less money than they did, significantly less money—

Mr. CAPUANO. You are telling me that it is not a result of the FHLB policy; it is a result of the market?

Mr. GIBSON. It is a result of the market, yes, sir.

Mr. CAPUANO. Mr. Zimmerman?

Mr. ZIMMERMAN. That is exactly right.

If you take my bank as an example, my bank is the most profitable. We have the happiest customers when we are making a lot

of loans. And most of the money that we have at the bank is out in loans because that is the highest yielding asset that we have.

Right now, I have a $435 million bank. I have over $100 million in liquid assets. I don't want it to be that way. There is a lack of loan demand.

The Federal Home Loan Bank is a member-driven organization, so my Federal Home Loan Bank account rep wants me to borrow from him. And I have $100 million in cash waiting to make loans right now.

I am not going to borrow. Our history is in 2007, we had $25 million worth of advances that we had outstanding. As the crisis worsened, and our cash went down—because we were pretty highly lent out at that point in time—when we finally got to September of 2008, we had $51 million worth of borrowings from the Home Loan Bank.

So that is this idea of scalability.

When it was going from $650 billion to $1 trillion, that was partly because of my bank. And if you take the same thing and apply it to other banks around the country—so we are not in normal times. And there isn't loan demand out there.

And I hear this too. But I can tell you in Pittsburgh, we are trying to make loans every day. We are advertising for loans.

We are going to meet small businesses. We are trying to convince them. But even my best customers are so unsure about the economy that they aren't willing to take that commitment and buy the next new machine, or add on to their business. It is the overall economic environment.

And so what you are seeing as too much liquidity at the Federal Home Loan Bank, is what I see as too much liquidity at my bank. And it directly affects them because I am not borrowing.

Mr. CAPUANO. It is not that I see too much liquidity. I see too many people sitting by the sidelines. And I am trying to get as many people as I can to get into the game. And the way you just described it, you are not the problem. You want to get in the game too.

So I am just trying to help you guys loan money.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman, Mr. Fitzpatrick, is recognized for 5 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I want to follow up on the chairman's comment earlier, and his questions about what is the right number of banks in the System.

Mr. Costa, as you know, the Federal Home Loan Banks are jointly and separately liable for the debts of the other banks in the System.

Are you concerned at all that the Home Loan Banks in other districts may be taking unnecessary risks, thereby placing the bank in your district in some jeopardy?

Mr. COSTA. As a banker, my profession is being concerned. So we spend a lot of time being concerned.

But I would say from my involvement with the Federal Home Loan Bank System, it is a very well-run System. All the banks are aware, and have become more aware since 2008, with what "jointly

and severally" actually means. And there is, I would say, a heightened awareness across-the-board.

I don't believe that any of the banks feel that we should not have those banks around. I think there has been some talk about some banks possibly merging together. But as far as I know, that has never gone beyond informal discussions.

I believe that the System works, and it has worked for 80 years. And we are all well aware of the responsibilities that each bank has jointly as well as severally.

I don't see any—certainly in the New York district, which is a very strong district, I have never heard any talk of overriding concern. Concern, yes, but not an overriding concern that we should consolidate out some of the banks.

Mr. FITZPATRICK. So, not enough of a concern that you would actually make a suggestion that something should be done to make certain that risks staked by other banks might have an impact or recommendation.

Mr. COSTA. I would say yes.

Mr. FITZPATRICK. Do any other panelists have any recommendations?

Mr. MORRISON. Let me just make a comment about consolidation.

Lots of people have talked about consolidation over the years in theoretical terms. This is a cooperative.

Consolidation would save some money, but the members have never thought it was worth saving that money to give up certain other advantages. I don't think it is something to be imposed from the top. I think it is something that if the members believe that they want consolidation, it should be facilitated.

And I think the statute is not as good as it could be if that were to come about. But the idea that Congress, or the regulators, would dictate that it would be better if there were 8 rather than 12 would be a mistake. We can all have those opinions, but ultimately the opinions that count are the members.

Now as far as risk, I think there is risk, and it should be discussed. And it has mostly to do with investments.

But advances are about the safest assets there are in the financial System. So in terms of risk between banks, I think it is pretty well regulated in that regard.

Mr. COSTA. I am sorry.

I would also point out that the Home Loan Banks are really cooperatives. And as such, we are looking over each other's shoulders all the time.

Everybody is looking at everybody else. So there is very little investing going on out there that is not under the purview of other banks and other members of those banks.

Mr. GIBSON. Whether 12 is the right number or what the right number is, Congress has given us the ability to voluntarily merge.

I know in the case of Dallas, we did have merger talks with another bank. They did not come to fruition, but I know that our board would certainly entertain a merger if that made sense.

The thing I will tell you, though, is that having a number of banks mitigates the risk. Because one of the things I look as a community banker, and as a board member on the Home Loan Bank is concentration of risk.

If you put all of this together in one organization, then it is going to look like some of the other agencies that had problems. This way, we are able to mitigate the risk among 12 different management teams that approach things just a little bit differently.

So I think that is an important thing to take into consideration also.

Mr. FITZPATRICK. Congressman Morrison, can you talk a little bit more about the affordable housing component of the Home Loan Banks? How do you believe the programs have performed and do we need to make any adjustments?

Mr. MORRISON. I think they performed very well. I think that the only criticism I would have of them is that they are not big enough.

They are uniquely member-driven and community-driven among all of the housing programs that are supported by government or by government-assisted entities. And in that flexibility, they have worked very well with community housing organizations.

There are two things they have done that have not been done nearly as well by anybody else. First, to provide quasi-equity in the area of very low-income multi-family housing, and they have done that as no one else has given flexibility to developers that they can't get anywhere else.

And second, they created a single family program where matching grants with savings became the driving force. And that is one of the most constructive things you can do for low-income people who want to acquire a home is to get them in a savings program to build up their own equity, and to build up a pattern of savings so they will be able to sustain the home.

Those are two things that they have done very well. I would like to see the program bigger, and I think it could be bigger. But it is up to Congress and the banks.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. Thank you.

Now, the gentlewoman from New York, Ms. Hayworth?

Dr. HAYWORTH. Thank you, Mr. Chairman.

Mr. Costa and Mr. Zimmerman, if I could ask you, just about the magnitude, if you will, of the FHLB's importance in your plans and your dealings with your client universe.

If FHLB's role were to become more limited, what would you do? And Mr. Costa maybe you can take this first, and then Mr. Zimmerman? What would you do as an alternative? What would you seek as an alternative in terms of access to funds?

Mr. COSTA. When you say a more limited, I presume talking about advances?

Certainly, it is an important part of our operation and our thinking that the Home Loan Bank is there to provide a smooth-out for us of—you can't always predict when deposits will come in, how fast they will come in.

As Mr. Zimmerman said earlier, deposits are flowing in now, but sometimes they aren't flowing in. And investments, when they are there, need to be acted on.

Things change constantly and if you are unable to act, so the ability to go to the Home Loan Bank, get an advance, carry out your project, and then as deposits come back in fund away the Home Loan Bank advances, helps to smooth that out.

There are other ways of doing it, but they are limited. Some of them are capital dependent. Some of them restrict particularly smaller institutions such as myself.

We were talking earlier about the importance or lack thereof of the larger banks being involved. The larger banks provide the ability for the whole System to borrow at the most favorable rate.

If they were limited or out of the System, I don't know if the Home Loan Banks could perform at the same level and do the kinds of things they are doing.

So I think they are vitally important.

Would we find other ways to do it? Yes.

Would they be as effective? I doubt it.

Dr. HAYWORTH. Thank you, sir.

Mr. Zimmerman?

Mr. ZIMMERMAN. That is my thought too. Basically, I can tell you in the case of my bank, without the Federal Home Loan Bank, there is no way that I could access the money markets.

We are $435 million. That is not even a dot on the spectrum in terms of—if I went to the rating agencies and said I want you to rate my bank, they would laugh at me.

Basically, they can't take the time. And so, I can't get a rating.

So I can't issue a debt instrument or anything like that at my bank and get money at nearly the cost that the Federal Home Loan Bank can raise it.

What happens is the consumers are the ones who benefit because when I get an advance at a very, very good rate, and I then lend that money out to whether it is a small business, or residential housing, or whatever it is, the consumer benefits from that low rate.

So I am able to be more effective and pass that savings on.

And the rest of your question is, where would I go?

I would probably have to go to one of the larger banks. Like in my market, PNC Bank is the dominate player.

I could go and offer up collateral and borrow money from PNC Bank, but there is no way that I would be able to get money at the same rate that I get it from the Federal Home Loan Bank.

And again, I am here representing ICBA. There are over 7,000 community banks in the United States, and most of them don't have the ability to go get money in the money markets.

You take the Federal Home Loan Bank away, all those people won't have access to low-cost money. It would make us very, very uncompetitive. We would have a very difficult time competing with these larger banks that basically dominate most of the markets.

So I can't really emphasize how important it is to have those advances available. And for the reasons that the other gentleman said, to smooth out when deposits are great, that is fine. You don't need advances.

But when you don't have the deposits, the consumers are making these decisions. We are not making decisions for them. The consumers decide on their own when they feel safe, and when they don't feel safe. That has a lot to do with when they give us deposits and when they don't.

Dr. HAYWORTH. Thank you.

And Mr. Chairman, I yield back.

Chairman NEUGEBAUER. Thank you. I appreciate that.

Mr. Capuano?

Mr. CAPUANO. Thanks, Mr. Chairman.

Mr. Morrison, I want to follow up a little bit more on the affordable housing aspect. It is my understanding that the FHFA has suggested that the Federal Home Loan Bank punch up the amount of money put into the affordable housing program.

Is that correct?

Mr. MORRISON. I actually don't know if they have done that.

At the time that the affordable housing program was created, two obligations were imposed on the banks. Essentially, 10 percent of their earnings for the affordable housing program, and what became 20 percent of their earnings for paying down a portion of the Refcorp bonds that paid for the S&L bailout. Because of an accelerated schedule that was in Gramm-Leach-Bliley, they have now paid off that Refcorp obligation.

A choice was made to invest those funds in a retained earnings account. It could have been invested in the affordable housing program or in an economic development fund similarly.

I don't know that anybody has asked for that to happen. I regret that it wasn't done, because I think those funds were being used for public purposes. And they have now been diverted to essentially private purposes by building up the capital of the banks.

I don't think there is anything wrong with building up the capital of the banks, although I have questions about the capital structure. But I think that the banks were able to discharge the public function with 30 percent of their earnings, and I think it is disappointing that we have lost some of that.

Mr. CAPUANO. Mr. Gibson, am I correct in my understanding that there has been a suggestion or proposal to strengthen the affordable housing component?

Mr. GIBSON. In terms of the percentage, I am not aware of anything that is forthcoming out of the agency. But I could be mistaken on that. I am just not aware of it.

What I will say is that when we made the decision to go into the capital enhancement initiative, we had just come through the greatest crisis since the Depression. I think we all learned a number of lessons, and one is you can't have too much capital.

And—

Mr. CAPUANO. I have nothing against capital—

Mr. GIBSON. Right. No, I understand.

And so we—

Mr. CAPUANO. But I do think that there are limits to it too, in a thoughtful business sense.

Mr. GIBSON. Agreed. The other thing—and our capital—what we have agreed to do is take 20 percent of the profits until we reach 1 percent of assets. So it is not like we are going to continue to grow that to some huge percentage number.

The other thing I will tell you is that the 10 percent is a required amount, and that is the minimum.

I know at the Dallas bank—I can only speak for what we do there—we exceed the 10 percent. We put in new programs all the time. They go beyond the 10 percent.

We just had a program approved whereby we are going to have a program to assist Purple Heart recipients since 9/11 who have come home with injuries, in order to help them rehab any housing that they are going into, expand doors, pull bars, things of that nature.

So we have done things like that outside of our 10 percent commitment.

And I can give you many other examples.

When Hurricane Katrina hit—Louisiana is in our district. We allocated, I think it was, $5 million additional monies for that.

So we go beyond the 10 percent. The 10 percent is just a minimum. And we do a lot of good things in affordable housing.

Mr. CAPUANO. Thank you.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. The gentleman from Florida, Mr. Posey, is recognized for 5 minutes.

Mr. POSEY. Thank you, Mr. Chairman.

Each of you used the term "liquidity" extensively. And unlike the gentleman from New Jersey, where the answer you gave the gentleman from New Jersey, in my area, there is a lack of liquidity on the streets, because of a lack of a desire of lenders to loan the money.

There is plenty of demand.

We have attempted to look at shoring up liquidity. And one of the ways we attempted to do that is by restraining overzealous efforts by regulators.

I won't ask their view about that, because the bankers who talk to me, every single one of them without exception have told me how they have been beat up by regulators. But they are scared to death of retribution, so I can't use their names.

And that is understandable. There are no laws on the books now to stop the retribution. There are no laws on the books to stop the abuse.

We have a bipartisan attempt under way to invoke a little common sense. And that is what I am going to ask for your comments on.

We would like to have a loan which has never been delinquent in the past 6 months, even 1 day or 1 minute late, defined by the historical definition of a performing loan.

And for at least 2 years to recover from this crisis, forbid the regulators from putting performing loans on an actual basis.

They could still investigate him for fraud. They can still do whatever they wanted to do.

They just couldn't suck the liquidity out of the bank—like any negative thoughts about that you may have.

If any of you know a downside to doing that—I am not asking you to support it. I would just like you to tell me if you know of a downside to that, while we happen to have you all here.

Mr. ZIMMERMAN. I will start.

I think that unfortunately, some of these problems are just going to take time.

And I think the best thing, rather than getting very specific about what is a performing loan, and what isn't a performing loan,

I think there just needs to be common sense at the regulatory level that basically says, look, these people know what they are doing.

It is not like you wake up one morning and take a stupid pill—

Mr. POSEY. I want to cut you off. We have had 2 years of hearings of regulators, and they say, yes, we are going to use common sense. But there is absolutely no forbearance.

So if you modify a loan, it is going on that accrual. If the parents make a loan for their children, it is going on an accrual.

If corporation A makes a payment for corporation B, it is going on an accrual.

And if we think, in our infinite wisdom, that this hotel where you have $800,000, 30 percent loan to value ratio, that has never been 1 day late in the 6 years, if in our infinite wisdom, we feel they should not be able to actually make that payment, we are going to put it on that accrual.

That is what I would like you to address.

Mr. ZIMMERMAN. To your point, there is an interesting difference though. In the residential lending area, the regulators are encouraging banks to forgive debt, to take funds, take a loan where they own $100,000 and say, if you can only afford $80,000, we will forgive $20,000 worth of the debt. And now, you owe $80,000 and we will reset your payment.

That is all okay. It is not a classified loan. You don't get written up for it or anything like that.

Over on the small business and commercial side, it is exactly what you stated, Congressman. If you do anything that is in anywhere near that, it is a problem.

It is a classified loan. It is an impaired loan. There is all kinds of extensive reporting you have to do.

And again in those cases, they are making us classify loans that aren't even delinquent. Because like you said, they feel that the borrower may not be able to make the payments.

So there is a strange dichotomy where what is okay to work with customers, give them forbearance, get them on a repayment plan where they can catch up is okay on the residential side. It is not okay on the commercial and small business side.

And so back to your point, Congressman, if you want to get things moving, I think that is an area where there could be some attention given. And let us make it okay to work with all the borrowers, not just some of them.

Mr. POSEY. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Fincher?

Mr. POSEY. I think Mr. Costa wanted to respond.

Mr. COSTA. I just wanted to say that following up on Mr. Zimmerman, there is now coming out new TDR, troubled debt restructure, guidance. Best practices, as the regulators call it, that requires you to treat any loan with any change whatsoever in it as a TDR, unless you can prove otherwise.

So that puts a pretty big damper on how everybody looks at things. It is an ongoing and very real problem.

Mr. POSEY. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Tennessee, Mr. Fincher?

Mr. FINCHER. Thank you, Mr. Chairman.

Mr. Gibson, do Federal Home Loan Banks consider risks when making advances? And if so, are interest rates on advances adjusted to make advances relatively more expensive for member banks?

Mr. GIBSON. We are—the first thing I would say is we are a co-op. And so we treat everybody equally.

We do evaluate the risk. And where we are evaluating the risk is in the collateral.

So if someone brings collateral that is not quite the quality that someone else brings, then we are going to loan them less dollars on that collateral, as opposed to the better collateral over here where we will loan more dollars.

So that is where we equalize it. The pricing is the same for everybody, because we are a co-op.

Mr. FINCHER. Less quality? What do you mean by less quality?

Mr. GIBSON. Let us say that it is maybe not as liquid a loan. Maybe it is raw land.

We may haircut that significantly more than we would a single family loan that is much more fungible in the marketplace, and we can apply a better value to.

Mr. FINCHER. Okay. If interest rates on advances are not adjusted, are other terms altered in some way to take risk into account?

Mr. GIBSON. Yes. If a member becomes a troubled member, we will continue to advance to them, as long as they have acceptable collateral. But the maturities begin to shorten.

And so we do shorten those maturities. We are not going to allow them to take out a long-term advance. We are going to make it a short-term advance.

If they become more—and when I say troubled, it could be somebody that has become a three-rated bank. They are not on the verge of being closed, but they certainly aren't a one or two-rated bank any more.

So there are different levels that we go to in the collateral requirements. And, yes, we do make adjustments there.

Mr. FINCHER. Mr. Morrison? Do you have any comments?

Mr. MORRISON. Yes. I don't think that the way in which the banks manage advances is a problem. I think their credit policies and their monitoring of collateral are generally very good.

And I think that kind of credit problem has never been central, and that is why they have never lost anything on an advance.

There was a time when there was a conflict of interest when the Federal Home Loan Bank board was both the regulator of institutions, also the insurer, and also the supervisor of Federal Home Loan Banks. And in that world, there were conflicts and lending was done to support regulatory objectives. And that conflict was removed from the System in 1989.

Since then, the banks, I think, have been very straightforward in there. So there are differences in pricing, but they reflect volumes of lending more than they reflect credit quality. And they cut people off except with consent of FDIC or another regulator when they go below a certain credit standard.

Mr. FINCHER. Thank you.

I yield back, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

Now the gentleman from New Mexico, Mr. Pearce, is recognized for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

I will just address this to any one of you. When we start having difficulties in the regional co-op, what are the corrective measures that you see taking place as we get deeper into the problem area?

Mr. GIBSON. Are you speaking at a specific regional bank?

Mr. PEARCE. No. If we have a specific regional bank that begins to get—

Mr. GIBSON. Okay—

Mr. PEARCE. —underwater, and they begin to accumulate more of the loans they have given, taken, whatever that are not performing.

So what do you see happening then to the operating unit?

What corrective measures—

Mr. GIBSON. There is—

Mr. PEARCE. —has been dividends, what do they do?

Mr. GIBSON. Yes. There are a number of things they do. First, they look to the primary collateral that they loaned against. Then, they look to the super lien status that they have for additional collateral.

Then, they look to that member's capital stock, because we are kind of the original skin-in-the-game group. And usually they are going to have capital stock for their activities somewhere in the range of 4.25 percent.

We are going to look to that capital stock. Then we are going to look to the earnings in that specific bank—one of the 12. The earnings and the retained earnings to cover any issues that comes up. And then we look to the capital stock in that area.

Prior to getting to that point, you would see suspension of dividends. You would see suspension of stock buybacks in that region. And then—

Mr. PEARCE. Have we seen any of those things taking place?

Mr. GIBSON. We have seen in some of the banks, yes, suspension of dividends and suspension of stock buybacks, that is correct.

We have not ever reached the point where we get to the actual capital stock of that specific bank's capital stock for their members.

If it happened to go beyond that, then we jump to the joint and several, and we have all of those issues that we go back to among the 11 banks.

Basically, the System is structured so that we should never suffer a loss at the System level, by one bank that would ever cause us to have to take any taxpayer funds. And we have never had to.

Mr. PEARCE. There is the possibility, though, that causes us to ask questions up here.

Mr. GIBSON. No, I understand.

Mr. PEARCE. Mr. Zimmerman, you said that there is no other access to capital. If you took at a look at the entire System, all 12 regional banks, how much dollars and margin, how much profit, if you want to call it that, did they have at their peak period?

Forget right now because we are kind of in a strange period, but just roughly.

Mr. ZIMMERMAN. Congressman, I don't have that information readily available to me.

Mr. PEARCE. Is it $1 billion, $10 billion, $100 million—

Mr. ZIMMERMAN. It is just that the System ran—I can tell you that the System ran very profitably and allowed reasonably large sums of money to go into affordable housing and things like that.

Mr. PEARCE. But it ran very profitably.

Mr. ZIMMERMAN. Yes—

Mr. PEARCE. —which is the key in—

Mr. ZIMMERMAN. Right.

Mr. PEARCE. So with all due respect, if—and you are saying that you couldn't find this liquidity, you are saying, let us say it is $1 billion.

You don't think there are enough players out there that would go after $1 billion net profit if the regional banks were not there. That is—

Mr. ZIMMERMAN. I think I had better understand—

Mr. PEARCE. Okay, sorry.

Mr. ZIMMERMAN. In my case, I could borrow money from somebody besides the Federal Home Loan Bank. I think the key point is I can't borrow it at that low of a rate. So let us just say the Home Loan Bank will lend me money and we will forget about today's rates, because they really don't really make a lot of sense.

But let us just say that they would lend me money at 4.5 percent. It is very likely that if I went to PNC Bank, with essentially the same collateral that I used with the Federal Home Loan Bank, I could pay 100 or 200 basis points more for the same money.

And then again, what happens is when I lend that money to my borrower, I have to charge them a higher rate. So it is—

Mr. PEARCE. Okay, I understand where you are going. Let us back it up.

But you are dealing in a System that has a market player in that slot?

Mr. ZIMMERMAN. Right.

Mr. PEARCE. You are telling me that if the FHLB was not there, that you don't think that you would want to find that $1 billion worth of profit and go organize a group to slide in there and loan at the same things, make the advances at the same rate.

I just don't—

Mr. ZIMMERMAN. I don't think I could form a group that could go into the money markets and be a AAA borrower, and get money at the rate that the Federal Home Loan Bank can get it. I think that is the rub here.

You can go in and get funds, depending on the size and scale and things like that. But the key issue here is this AAA or really AAA rating.

Mr. PEARCE. Yes—

Mr. ZIMMERMAN. And you can't replicate that. Forming a group or another co-op probably wouldn't have the same high credit quality. And my guess is that it wouldn't be able to raise money at those extremely low rates.

Mr. PEARCE. Yes, okay.

I see my time has expired, Mr. Chairman.

At the end of the day, you have to ask if it won't happen in the market, why are we guaranteeing it from taxpayer funds?

I think that the model sounds like it makes money. I think that somebody would open up. But we really do—I am one who hates that we are sitting here bailing out Fannie Mae and Freddie Mac.

Mr. ZIMMERMAN. But remember, the group we are talking about was not bailed out. They have never taken a dime—

Mr. PEARCE. No, I understand—

Mr. ZIMMERMAN. —from the government. And remember, the money the customers, the American citizens, actually benefit from this because all of our customers, all the community banks that are making loans out there every day using Federal Home Loan Banks as the source of funds, those loans we make are at lower rates. And so there is all every day citizens, every day benefiting from the fact that this System exists, that this co-op—

Mr. PEARCE. I don't take issue with that. We have had to look at that implicit guarantee. I think that is—thank you, Mr. Chairman, I have extended too long.

I am sorry.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from New Jersey, Mr. Garrett?

Mr. GARRETT. Thanks, Mr. Chairman, and I thank the panel.

I have heard everyone say what a good job the Home Loan Banks have done. And I agree that they have done well and weathered the storm well.

And to the point, Mr. Gibson, both here and in your written testimony, you said the same thing, that things are going well.

But we do note some notable exceptions out there and we read about in Chicago and Seattle and Des Moines and elsewhere where they are having problems.

So maybe there is some room for improvement. I know in your testimony you talked about how you have a little bit of a push back to what the Administration has said, and the FHFA has said as far as their recommendations.

So if you push those aside, do you have any recommendations for improvements to the Federal Home Loan Banks?

Mr. GIBSON. I think you have to—the one thing I would say is, yes, I acknowledge that a few of the banks do have some issues.

Those issues are primarily related to the private label mortgage-backed securities which were AAA rated at the time they were issued. They are working though those issues.

The System has remained profitable throughout this.

In terms of recommendations to improve the System, there are always opportunities. Nobody is perfect.

So, yes, there are opportunities.

But what we would encourage is that the model and the structure be looked at carefully because it is very interdependent. And if you change one thing it could have unintended consequences somewhere else, and maybe not prove to be quite as successful as we move through all these different economic cycles.

Mr. GARRETT. Okay, I get that. And if you have any specific ones, we would love to have—myself, and I am sure the committee as well.

Does anyone else have any specific recommendations that you would like to set forward today?

Yes. So one of the reasons might be because I think in your testimony you say that well over the history, there haven't been any losses with regard to the advances, right?

Mr. GIBSON. That is correct.

Mr. GARRETT. Now my understanding, and that might be in part because vis-a-vis the FDIC—what you all have, is what, a super lien position, right?

Mr. GIBSON. That is correct.

Mr. GARRETT. But for that super lien position, when you have some of these larger loses where the FDIC had to step in such as IndyMac, in which case what, the taxpayer effectively is on the hook there.

For example, let us use that one. Had you not had—not you—but not had the super lien position, would there have been losses absorbed by the member banks as opposed to the FDIC and the taxpayer?

Mr. GIBSON. I think the key there is that we only loan against quality of collateral. If the quality of collateral is not there, we don't loan against it.

Mr. GARRETT. At IndyMac, there was significant overcollateralization, right? That was the problem, 220 percent. And so with the in that case, I guess it was the problem.

Mr. GIBSON. Had we—

Mr. GARRETT. I know—

Mr. GIBSON. Yes, they are—

Mr. GARRETT. I get you.

Mr. GIBSON. —they are not in my footprint, so I don't know all the particulars about IndyMac. But my guess is that if we did not have the super lien position, and we simply had the specific collateral that the number of advances would have dropped precipitously.

The reason IndyMac closed in the end was not credit, it ended up being a liquidity run. We are required by statute to work with their primary regulator when they run into those liquidity issues.

The Federal Reserve, by law, cannot loan to a five rated bank. So, the Home Loan Banks are the only option.

And, one of the things the FDIC does well is arrange orderly liquidations. We are the only source to be able to help the FDIC arrange orderly liquidations.

Mr. GARRETT. So the FDIC position of the super lien is beneficial to the FDIC?

Mr. GIBSON. I do not know what the FDIC's position is.

Mr. GARRETT. I wouldn't—

Mr. GIBSON. But I would say—

Mr. GARRETT. —I wouldn't think so. We are talking about another area where they accuse us of trying to set up a super lien position. And they don't usually like that.

Mr. GIBSON. But I would say that we only loan against quality assets. We do not encourage bad lending. Because if you—

Mr. GARRETT. I understand.

Mr. GIBSON. —have bad lending, we are not going to loan you any money against it.

Mr. GARRETT. I will throw it to Mr. Morrison on that point, and also—I see my time is just about wrapping up—as far as how do you put the subsidy onto the balance sheet which it seems would be something that you would be favorable doing, right?

Mr. MORRISON. Yes. I would say first, I think you are absolutely right in your analysis that the super lien does shift the burden of the loss to somewhere else. And that is why it was passed in 1987 because the S&Ls had losses.

And there was a decision to benefit the banks over the insurance fund.

Mr. GARRETT. I get that.

Mr. MORRISON. And so that conflict does exist.

I think the banks are not profitable lenders. I think that it is a rare case where this problem arises, but it does arise. And they have had some very big failures like WAMU.

So this is a real issue in terms of the FDIC. If you ask anybody who has been in a credit competition with the FDIC, you will find out that the FDIC has very powerful statutes. And you may have perfected loans and you may find out that you are not perfected.

So there is a reason for it. It is a practical matter.

I wouldn't suggest that you change it. But I would just suggest that the rhetoric about never having a loss is sometimes stated with a little bit too much force.

And in terms of the guarantee, I don't think we should have, as a country, pledges on behalf of the taxpayers that are not funded up front. And I think there is an argument for having explicit guarantees.

People can disagree about that, but if you are going to have them, I think you ought to have to pay for them up front like we pay for FDIC up front.

And so I think that either you make it explicit, you score it, and you collect money for it, or you shouldn't have a guarantee.

And that takes you back to what Mr. Zimmerman was talking about. Could you have a private System that would work? Or is the margin that is the benefit of the implied guarantee—or the 25 or 50 basis points gained in the marketplace—what it takes to make the System run.

I don't know the answer to that. I think it would be a scary experiment because you might lose the community bank focus.

But I think that if you are thinking about explicit guarantees, you ought to think about community banks. And you ought to worry a little bit about Wells Fargo, and Bank of America, and all these other large institutions which are perfectly good institutions, but also represent a big piece of the balance sheet of the Federal Home Loan Banks, and should they get the subsidy.

Mr. GARRETT. Thanks. I appreciate that.

Chairman NEUGEBAUER. I thank the gentleman.

Now, the gentlelady from California, Ms. Waters?

Ms. WATERS. Thank you very much, Mr. Chairman.

I want to ask a question that you may not feel is directly related to what you do. But I am concerned about all of these REOs out there.

Right now the banks have on their books thousands upon thousands of Real Estate Owned properties, or REOs, similarly between FHA, Fannie Mae, and Freddie Mac.

The government owns about 300,000 REOs.

Do you have any thoughts about the best way to dispose of these assets?

Do we need to create something like the Resolution Corporation?

And is there a role for the Federal Home Loan banks to play if such an asset disposition structure was created?

Anybody? Somebody?

Mr. ZIMMERMAN. Again, you asked, so I think that it would be very difficult to set up an organization and to fund it and staff it and so forth. The amount of expense and the delay in time of trying to do that, until you actually got a result, would be very, very difficult.

I, unfortunately, think—and I touched on this a little bit ago—that it is going to take more time because the market needs to work. And these properties need to work their way through.

Unfortunately, there were a lot of people who got houses, bought homes not for the right reasons necessarily, and so those are out there. They couldn't afford them. Now, they are an REO, as you are pointing out.

And it is going to take a while for the market to absorb that, but the market will absorb it. It will work its way through.

And it is just like trying to accelerate that by creating some kind of other structure like the Resolution Trust Corporation, I think would have problematic results, because—

Ms. WATERS. But let me ask you this. Over the past several months, I keep hearing about groups that want to purchase all of these nonperforming assets.

And they say, "We want to rehab them. We want to keep people in them. We will rent and maintain them as rental units. And then we will have rent-to-buy."

We think that it made good sense to take these nonperforming assets and turn them into performing assets.

And they keep talking about how they have the money, that they have individuals who have come together who have put together a pot of money to do this. And I hear nothing from anybody about a response to this.

Have you been hearing this?

It is something like what PennyMac did after the guys left from over at the bank that was purchased—Countrywide. Remember when Countrywide—?

Some of the guys who were high up in Countrywide, they first left and they created something called PennyMac. And they were supposed to do this kind of thing.

And then I heard nothing. It just kind of fell apart.

Mr. ZIMMERMAN. I think it is a viable solution.

If there are groups and they want to buy assets—and I can tell you, again, from personal experience, if a group came to my bank and said they wanted to buy my real estate-owned properties from me in a group, I would tell them I would meet with them anytime, anywhere, to talk about—seriously—because if they have money and they want to do it—because I am a banker.

I don't manage properties. I don't rehab properties. I am not an expert at that. I don't know exactly the best way to do that.

So if I could give it to somebody who can—

Ms. WATERS. It has to be discounted though.

Mr. ZIMMERMAN. They do. And of course, then it becomes the price.

And so my suspicion is that some of the groups that you may be hearing from want to buy some of these properties at such deep discounts that you just can't let the properties go for that price.

Ms. WATERS. But it is negotiable isn't it—

Mr. ZIMMERMAN. Giving them away.

Ms. WATERS. Can't you negotiate that?

Mr. ZIMMERMAN. Yes.

Ms. WATERS. Given that you have all these properties that are underwater anyway, they are not what they were when the mortgages were written on them.

There seems to be some room here—

Mr. ZIMMERMAN. There is—

Ms. WATERS. —in order to write this down, that people could come to some agreement. But I see no movement in this direction anywhere.

Mr. ZIMMERMAN. And all I can tell you from the bankers' perspective is that we are not experiencing people coming to us with real money wanting to do this. I can personally say no one has approached us—

Ms. WATERS. Can I send you some people who keep coming to me, telling me about these?

Mr. ZIMMERMAN. I can't—

Ms. WATERS. So you can hear their stories.

Mr. ZIMMERMAN. I have some real estate owned, and I would love to talk with them, so send them my way.

Ms. WATERS. All right. I need to get rid of them, bugging me, because I don't know what to do about it.

Mr. MORRISON. Congresswoman?

Ms. WATERS. I am sending them to you.

Mr. MORRISON. Congresswoman?

Ms. WATERS. Thank you. I yield back the balance of my time.

Mr. MORRISON. Congresswomen, let me just make a comment.

I was around here when we did RTC and RTC worked. It was under a Republican President, so it is not some left-wing idea.

It is something that requires a mandate. And it is not going to work voluntarily. Quite frankly, all of the emergency mortgage relief programs that we have had have operated on a voluntary basis, and they frankly haven't worked.

And it is unfortunate because we have a lot of Americans suffering. So the question is, is there enough consensus up here to create a mandatory solution?

If there isn't that consensus, then you are going to rely on the market to come up with a solution. And I frankly think that is where the problem is.

Ms. WATERS. Thank you.

Chairman NEUGEBAUER. We are going to do another round as Members would like to do that.

So I am going to start.

One of the recommendations recently from Treasury, as it relates to the Federal Home Loan Bank System, was that some of the larger banks are taking advantage. We have had a lot of emphasis on community banks. And I come from an area where we have more community banks than we have large banks.

But I think, Mr. Morrison, you alluded to this—is why should these guys that would be your alternative if there wasn't a Federal Home Loan Bank, why should they be eligible to come in and leverage off of the borrowing rates or the home loan System.

Because I understand, and I don't have those numbers in front of me, but I think when I was getting briefed that 70 percent of the advances or maybe 80 percent of the advances or to about 20 percent of the members and that there is—of those numbers, a lot of large banks.

So what is the benefit of letting the large financial institutions, is the Treasury Secretary made sincere, maybe not value add?

Mr. GIBSON. I will be glad to start on that one.

First, it is mission-consistent. One of the missions of the Home Loan Bank is to provide funding for housing.

Our top 10 borrowers, which I think would encompass the large banks that we are talking about, represent 38 percent of the borrowing at the end of June 30th, I believe.

These institutions represented 68 percent of the mortgage originations in 2010. So it is definitely mission-consistent. They are heavily involved in housing in this country.

Second, they act in the scalability issue to reduce the cost for community banks. And they do that in a number of ways: one, by having the spread on the advances that are out there; and two, they allow us the access to the global markets.

The global markets wouldn't be as deep and as liquid for the Federal Home Loan Banks without the size of the issues that we have outstanding. The earnings that they help provide build the retainer and help build the capital structure.

And then the last, and I think one of the really key things is that we have, in the mechanism, built-in corporate governance structure that does not allow them to have a disproportionate voting. We take the total number of members in a State, the total number of shares, and we divide that, and that is the maximum number of shares any institution can vote.

So in my case, Southside typically would have about 200,000 votes. I am limited to 30,000. And that is the maximum that anybody has of any of the large institutions.

So I think it is critical that we keep the large members because it acts to help the small community banks and provide the affordable lending all through the entire country.

Chairman NEUGEBAUER. Mr. Costa, and I think, Mr. Zimmerman, you both said that when you are able to borrow at a cheaper rate from your advances, that you had that opportunity to pass that along to your customers.

The question is, is the advance rate at all of the 12 Federal Home Loan Banks or is it the same rate, in other words if I was going to borrow from, say, Chicago, and I was going to borrow from Dallas. Would I be paying the same rate if I am a bank?

Mr. COSTA. I do not believe that the rates are exactly the same. The rates are probably fairly close, but each of the banks price their own advances. We don't get involved in price-setting or anything of that nature.

So each of the banks do have a little bit different pricing, but all the banks provide funding at a competitive level, because if they go too far outside the bounds, then there might be another source for one specific type of borrowing that they could borrow.

But no, I don't believe they are all exactly the same.

Chairman NEUGEBAUER. And don't we have banks that are multiple members of a number of regional banks, that they are not just a member of one?

Mr. GIBSON. We do. And in the case—some of these top 10 borrowers may belong to 2 or 3 different member banks. And that actually acts, once again it goes back to the concentration risk. The risk is spread among several banks, and there are several bank management teams looking at those.

Another key benefit is that if the large bank happen to be represented in one area, then all the profits from that and the affordable housing dollars would only flow to that one area, when most of those banks have tentacles that reach all across the country.

So it helps to spread the costs and it also helps to spread the benefits to the members all across the country.

Chairman NEUGEBAUER. Would anybody else like to comment on that?

Mr. MORRISON. Yes, Mr. Chairman. I would say everything that Mr. Gibson said is correct.

But there also is a substantial subsidy that is flowing to the largest banking institutions in the country. And that is a policy judgment for the Congress.

In my written testimony, I suggested a way to square that circle to allow those institutions access when there is a very specific kind of illiquid asset being supported, as opposed to just supporting the liquidity of those very large institutions.

There are benefits in terms of pricing, and there are benefits in terms of disciplining the System. Probably it would be better if all of the big institutions were spread around the 12 banks and there wasn't any competition for getting the big members in.

But it is a value judgment at the end. And I think that many Members here in other contexts, if they saw the subsidy to the particular institutions, would be disquieted by it. And I think people should at least understand it and decide whether or not they want to target it better.

Chairman NEUGEBAUER. Thank you.

You are recognized, Ms. Hayworth.

Dr. HAYWORTH. Gentlemen, as you know, the Financial Services Committee spends quite a bit of its time, rightly so, on Dodd-Frank. And I am wondering what, if any, anticipated burdens you see on yourselves, on community banks, on the relationship or the functioning of the relationship you have with FHLB or the functioning of FHLB related to Dodd-Frank?

I will throw that out to all the members of the panel.

Mr. GIBSON. I will start.

Dodd-Frank—it is hard when you go through a crisis like we went through, it is hard to say, "Gosh, we don't need any additional regulation."

I think there needs to be a cost-benefit analysis, though. In the case of the Home Loan Banks, our regulatory costs have tripled in the last 10 years.

I guess what I would say is we need to make sure we have smart regulation, not just additional regulation. So I would just leave it at that.

The costs are just going through the roof. And they are going through the roof at my community bank also, and I will let the other gentlemen speak to their instances.

Mr. ZIMMERMAN. Yes, I can pretty much ditto that.

If you wonder about a concern to get the economy moving, one of the big concerns is can we afford all the regulation that we are supposed to be able to handle and buck up to?

Because more and more and more doesn't mean we are going to prevent a problem or whatever. And I totally support the idea that there should be smart—you have to have regulation.

But we are regulating community banks particularly down to the point where there is barely room to breathe. That is not how you get the economy going. And that is not how you lend money out.

Mr. MORRISON. I just have to take a moment of personal privilege to say that the tripling of the regulatory cost of the bank System came precisely after I left my job as chairman of the Finance Board.

Perhaps because when I was chairman, and I got to set how much we were going to charge, I had experience up here, and I couldn't imagine just willy-nilly increasing the cost without having a sense of accountability.

I, frankly, think that the regulatory costs that have been imposed on the bank System have been unnecessary at the scale at which they have been increased because the regulatory focus should, I think, be more targeted. And it probably shouldn't cost quite so much as it does.

It is easy when you are in the business of both setting the spending and the taxing to do what is easy and comfortable, and increase both. But I think Members up here would have a different view if they were sitting in the Chair.

Mr. COSTA. I would just like to say, as the smallest guy up here, our bank is probably the average size ABA member out of all the banks. And the regulation doesn't take into account at all the size of an institution.

So the need for me to comply is really burdensome because of my size. It costs me just as much money to comply as it does a $3 billion bank, relatively speaking. And we just don't have the room for that.

So it has become a real burden for the average size community bank across the country, not just me.

Every time I go to a meeting, whether it is here or in some other part of the country with the ABA, everybody is saying the same thing, "This is killing us. Where does this end? How do we do this?"

They don't know how to do it.

So it is a real problem.

Dr. HAYWORTH. Thank you, Mr. Chairman.

I yield back.

Chairman NEUGEBAUER. Mr. Posey?

Mr. POSEY. Thank you, Mr. Chairman.

I believe Mr. Morrison hit the nail on the head when he said the solution is more about accountability than it is new regulation.

Ken Lay, for plundering Enron, went to prison. Bernie Madoff, although he had to basically turn himself in because the SEC wouldn't track him down, ended up in prison.

I am sure there were some people in financial institutions who were, at the very least, culpably negligent in causing a great harm to this economy, to this country.

To my knowledge, although I hear whispers and rumors of investigations, nothing has surfaced yet that has been significant. There has been no accountability for the wrongdoing that they did to harm their stockholders, their employees.

One would think—I think the common prudent person on the street would think that certainly that would be considered racketeering, certainly they had to use telephone, mail, other ways of communicate more than one thing. And somewhere, we have some people going after the people who perpetrated these great damages and inflicted this great financial injury on our country and our citizens, tracking them down and trying to bring them to justice.

I think that is the final accountability. I don't think when we have talked about it before, were to be ever smart enough to have a law to stop somebody from profiteering in every conceivable manner.

It is just the law of probability that says it's moot. But history has shown—and if we had time we could walk through the instances that when there was prompt and severe punishment for what these people have done, that stops the practice from repeating itself more than anything else.

So I am sorry for the regulations that you all have to suffer as we try and overcompensate for having not done the right things in the beginning. But I don't think all the regulations in the world are going to stop the bad guys from scheming and trying to take advantage of honest people and honest companies.

I think the only way we are going to do that is when we hold them accountable for that.

So any comments you have on that would be appreciated.

Mr. ZIMMERMAN. I couldn't agree more. It is this idea of when you look at where the problems were and then what the solution is, when you have all this regulation—and we are here speaking as community banks, and I think it is reasonably well-established now.

There is a pretty bright line between the big banks and the community banks. And the ones that caused the problem, go ahead and go after them.

But what is happening is one-size-fits-all regulation is happening. And we are expected to bear the cost, even though we didn't cause the problems.

And so there needs to be some kind of System where the people—let us go after the people who caused the problem. But don't

keep adding more and more regulations onto the people who didn't have anything to do with it and expect us to pay for it.

Because when the bank down the street closes in a small town, and they have to merge with a larger company because they can't afford the cost of regulation, the people in that area are hurt. The American citizens are hurt. And it is just not right.

Mr. POSEY. We have tried to make that point to the people who are trying to eliminate the 3 percent FHA downpayment loan, saying it would take the government off the hook.

But for 60 years that has worked. There has been a 0.5 percent MIP that has covered that. And by changing the game now, you only hurt the next generations of homebuyers.

You hurt the innocent people. You don't do anything to make the guilty pay.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

Now, the gentlewoman from California?

Ms. WATERS. Thank you very much, Mr. Chairman.

I was just looking at some of the information that was provided to us. We have a paragraph here that says, "During the financial crisis, as other sources of funding dried up, financial institutions turned to the Federal Home Loan Banks for advances for much needed liquidity. These advances may have kept some financial institutions from collapsing and may have delayed the failure of others long enough to allow merger or acquisition of another financial institution."

My first question is—we witnessed the closure of many community banks. The FDIC was closing them so fast they couldn't keep up with them.

And of course, we know that one of the problems of these small banks is access to capital. This is what we hear all the time.

I want to know, in all of these financial institutions that you saved, what percentage or portion of those Federal Home Loan Banks were small or community banks or minority banks? That is number one.

Number two, let me just say that there is a great deal of sympathy and support for community banks on the Financial Services Committee, on both sides of the aisle, and I think in this Congress.

As you know, during the Dodd-Frank Conference Committee, we looked at getting rid of an overabundance of auditors being in one bank at the same time. You hear a lot of us talk about the capital requirements. We would like to make sure that community banks are not overburdened with capital requirements that banks basically hamper them.

So on the latter part of this commentary, what are the specific regulations, would you advise us, that need to be eliminated or modified in some way?

So that is two questions. Who got saved?

How many community banks got saved?

Why are they still screaming about access to capital?

And what regulations could you identify specifically to tell this working group of members on both sides of the aisle, that I am speaking for, even though they didn't tell me I could speak for them—to help with the regulations problem?

Mr. GIBSON. I will start. I don't know the exact percentages, but I will tell you that the large institutions have always been considered too-big-to-fail. So I don't think that we were saving large institutions.

My guess is that the vast majority, if not all, were small community institutions that did not have that access. When the Treasury Secretary and Chairman Bernanke were in Washington meeting with bankers during the crisis, I don't think they were meeting with small community bankers. They were meeting with the big guys trying to figure out how to save them.

There is nobody out there when a community bank—any of the three of our community banks gets in trouble, there is nobody going to come help us. And so the liquidity provided that saved the banks would—my guess is, and I can get you the information, would have been the smaller banks.

In terms of regulations, the—

Ms. WATERS. Are you saying the Federal Home Loan Banks did the advances to the small and community banks?

Mr. GIBSON. I am saying that when liquidity dried up, and two things happened, especially in the third quarter of 2008. Liquidity went away for everybody.

Ms. WATERS. Yes.

Mr. GIBSON. And the ability to raise capital went away for everybody. Fortunately, the way the System works in the Home Loan Bank, we have a self-capitalizing model, and we were able to provide that liquidity.

So as long as a bank who may have needed liquidity could give us the capital and had the assets on balance sheet, we were able to give them the liquidity. And they would not have been able to get that anywhere else.

Ms. WATERS. Do you feel that your collateralization requirements are so awesome that some of the community banks could not apply for or be considered for advances?

Because I understand they have to offer—

Mr. GIBSON. Sure.

Ms. WATERS. —an abundance of collateral for you guys.

Mr. GIBSON. They have to offer quality collateral. And in some cases, some banks reached a point where they had made so many—and it was a small segment fortunately. But some of them had made so many bad loans that yes, there probably were instances where we just couldn't advance additional advances. We never took the advances away from those institutions.

But for those who were teetering because of a liquidity crisis, we were able to advance funds to those folks because for the most part, they had quality assets. They just didn't have any place else to go to get liquidity.

Chairman NEUGEBAUER. I thank the gentlewoman.

Ms. WATERS. Thank you.

Chairman NEUGEBAUER. Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

Gentlemen, let me ask you if you agree. I see the economic crisis having been—no one person or one group is to blame.

It is all of us, if you want the truth. But if I had to point to one person or one group, it would be the unregulated financial institutions that really went the craziest.

And it wasn't the—the regulated did some too. But the truth is if they had just held all the problems that we did have just within the regulated institutions, big and small, that we could have handled that without much of a problem.

It would have been a minor problem to some people, but not to the economy as a whole. The economy as a whole was shaken, in my opinion, because the unregulated institutions.

I guess the only thing I want to say is I wanted to follow up on what Maxine said. I want to be really clear.

I am a liberal, progressive, whatever you want to call me. I believe the government has a role to play in drawing lines, saying, "You can't cross this line," for a lot of people.

The classic one is that you can't murder anybody. We don't say you can't murder anybody because we think everybody is going to murder somebody.

It is just if you do, there is a consequence to pay.

And I look at regulations for the most part, not just with banks but all regulations, as the same thing.

At the same time, I was going to say I am the most liberal person in the room, but I don't want to offend Maxine, so—

[laughter]

I am not for overregulation. And I represented all the banks in Massachusetts for about 7 years.

So I understand what you are saying, but honestly the problem I have when my banking friends come in and say—and again, not just banking, but bankers in this committee—when they say, "Oh, there is too much regulation. Help us."

Now some of my friends here and I may have a difference of where the line should be drawn. That is fine.

But I have no interest whatsoever in driving up your costs on unnecessary, duplicative regulation. That is stupid. I am not interested in that.

At the same time, I need to know exactly what you mean. Today is not the day to do it.

So especially the groups, the ABA, the ICBA, and others, come in and talk to us. And not about, "Oh, there is too much regulation." That is great, but that doesn't help me answer the problem.

And I do hear on occasion—I have been here for 13 years. I do hear on occasion someone will come in about one specific regulation. It is usually about a proposed regulation that they don't like.

But I have never had a group come in to me and say, "Hey, Mike. Here are the 25 regulations that are killing community banks. And look, we don't need them. Here is why we don't need them." Not just, "We don't like them."

The truth is nobody likes—I would like to go do anything I want to do any time I want to do it. But I think everybody agrees that there is a need for some thoughtful, reasonable regulations. And not because we think you are going to break the law, but because we hope you don't and we want to make sure you know where it is—

It is also for competitive reasons, which is I think what got us in trouble, is that without regulation the human nature of competitiveness is once you start doing something, I had better start doing it if I want to compete with you.

And it just becomes unsustainable. So for me, regulations are about saying, "Here is the line. Nobody can cross it. And therefore everybody is on an equal playing field."

So I guess what I am saying is please, from the organization's standpoint, not here, not today, come in with a thoughtful, comprehensive proposal on how we can go about—with the reasons.

Okay, we don't like this regulation. This is why, or, you don't have to have this because we have to do the same thing here, or, we have to do this form for this agency and this one. It is the same form. Make them the same.

Those kinds of things help me try to help you.

Now again, we will probably have disagreement of where the line should be, but at least we will know what we are arguing about.

And I will simply say that when people come in and say there is too much regulation, it is a good political sound bite but it doesn't help the System.

And in the end what ends up happening is you end up having lots of regulations that are not enforced—which I also think is probably one of the biggest problems we have. And you have regulators who are afraid to regulate.

And you end up with nothing. And we end up with an economic crisis like we have now, and then you get an overreaction.

So for me, before we get too far down that road, I am begging you again, the associations, come in and talk to us about details and specifics and how we can move forward. Because even those of us who don't mind regulation, most of us—I am not interested in overregulation.

That is not good for business. That is not good for government. It is necessary in any way I can see it. And so therefore I am not against regulation, but I need help in trying to determine exactly where we should draw it.

Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

This has been a very good hearing. I appreciate the witnesses. I think we have had some good interchange. We had good participation from our membership today.

As you know, as we begin to try to reinstall and restart the private mortgage finance business in this country, the whole chain is going to be an important part of that.

And as we also try to figure out a way in the future of trying to decouple the taxpayers from picking up the tab when people make bad investment decisions, obviously that is going to be an important part of the discussion. But I thank the witnesses for your time today.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

So what that really means is some of our folks may want to follow up. We would appreciate your response. And then we will make your responses, again, part of the record.

And I thank the panel.

And with that, this hearing is adjourned.

[Whereupon, at 2:58 p.m., the hearing was adjourned.]

A P P E N D I X

October 12, 2011

Testimony of

Anthony P. Costa

On behalf of the

American Bankers Association

before the

Subcommittee on Oversight and Investigations

of the

Committee on Financial Services

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Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, my name is Anthony P. Costa, Chairman and co-CEO of Empire State Bank, a $165 million bank headquartered in New York's Hudson Valley. I am glad to share my experiences regarding the Federal Home Loan Banks on behalf of the American Bankers Association, where I serve as Chairman of the ABA Federal Home Loan Bank Committee. ABA represents banks of all sizes and charters and is the voice of the nation's $13 trillion banking industry and its two million employees.

The subject of today's hearing is timely. The Federal Home Loan Bank (FHLBank) System plays a vital role in providing mortgage finance and economic development to communities throughout the United States. The FHLBank System will undoubtedly be discussed in the context of work by Congress and the regulators to end the conservatorships of Fannie Mae and Freddie Mac, the Government Sponsored Enterprises (GSEs) that deal directly with secondary market housing finance. This discussion must focus on the FHLBank System's differences from those other two GSEs in purpose, structure and risk.

The FHLBank System is differentiated from the secondary market GSEs because of its history of financial stability, its higher statutory capital requirements, its mechanisms of joint and several liability among the 12 Federal Home Loan Banks and the cooperative capital structure of almost 8,000 members that is designed to protect taxpayers, and the plans recently approved by the Federal Housing Finance Agency to increase capitalization levels significantly above levels required by statute. As lawmakers consider changes affecting Fannie Mae and Freddie Mac, it is important to remember that any reform is likely to have an impact on the Federal Home Loan Banks. Great care must be taken with any reform of the secondary mortgage market to protect the traditional business of the FHLBanks and access to liquidity by their members. Failure to do so will have a detrimental effect on mortgage funding and home ownership for many years to come.

The FHLBanks are 12 regional cooperative banks created by Congress that provide banks with access to funding for community lending. The FHLBank System has been in place for eight decades, weathering the toughest economic storms, including the recent financial crisis. Banks like mine purchase stock in our regional FHLBank and become a member/owner. Because the FHLBanks are cooperatives and the stock is not publicly traded, there is no pressure for high rates of return or the risky business activities that accompany that strategy. Rather, as cooperatives, FHLBanks provide valuable liquidity to banks like mine so that we can make loans and fund the operations of the bank at a cost that is reasonable.

The importance of the role our FHLBank plays in our business plan cannot be overstated. Although it is not the only place we go to meet our liquidity needs, it is one of our primary sources. I can connect the funding of many individual loans directly back to FHLBank liquidity and funding. Many of our loans would not have been made were it not for our FHLBank.

There are three points I would like to make today that I hope will help illustrate the important role that the FHLBank System plays for banks across the country and demonstrate how critical it is that any reform of the mortgage finance system does no harm to the FHLBank System:

- **The Federal Home Loan Banks are essential to enable community banks to meet the needs of their communities.** Without the FHLBanks, community banks would not be able to reliably meet loan demand.
- **The FHLBanks performed exactly as intended during the financial crisis.** The FHLBanks continued to provide liquidity even as the credit markets largely froze up. This was a challenge, but they continued to meet their mission, because of the flexibility of the structure and membership in the system.
- **The FHLBanks' Programs provide assistance for the development and operation of affordable housing developments and collaborations.** The Affordable Housing Program and Community Investment Program help to fund lending that would otherwise be impossible.

I. The Federal Home Loan Banks Are Essential to Enable Community Banks to Meet the Needs of Their Communities

The central business of the FHLBanks is providing liquidity and funding to member banks in the form of advances, which are essentially loans that are in turn used to fund community development. To qualify for advances, banks members pledge high-quality collateral, in the form of mortgages, government securities, or loans on small business, agriculture or community development. Banks also purchase additional stock in proportion to their borrowing.

Banks can use funding from advances to facilitate lending in their communities. Let me give you an example. Loan growth often outpaced our ability to grow our deposit balances. Short-term FHLBank advances enable us to fill this gap and fund those loans. Moreover, longer-term fixed-rate advances allow us to better match funding and loan maturities. This is particularly useful in helping community banks manage interest rate risk. The FHLBanks allow banks to fund longer-term projects that might be impossible with only deposits, particularly in this low interest rate environment. By being able to more closely match Federal Home Loan Bank advances with various projects's average loan lines we do projects in the community that would not otherwise be possible with deposit funding.

Another source of liquidity for home mortgages available through the Federal Home Loan Banks is the Mortgage Partnership Finance Program (MPF). Through the MPF, mortgage risks are shared through a partnership that combines the retail credit expertise of a local mortgage lender with the wholesale funding advantages of an FHLBank. A variety of products ensures that mortgage lenders of all types and sizes can gain access to the secondary market. Empire utilizes the MPF to provide liquidity by selling qualifying residential mortgages into the program. We receive a competitive price on the mortgages as well as ongoing fee income for retaining a portion of the credit risk on the loans. ***Access to a market of this kind would be all but impossible without a vibrant FHLBank System.***

In addition to liquidity management through advances and the MPF, the FHLBank System also provides letters of credit for municipal bond issuances guaranteed by member banks. Through letters of credit, the FHLBanks pass through their high-quality credit rating to member institutions, while pledging to be a credit backstop. Larger FHLBank members can carry out large projects that use bond financing. The FHLBank provides a credit enhancement to the

bank's letter of credit on bonds, thereby assisting in lowering interest rates for municipal project financing.

Recently, there have been regulatory proposals to modify bank membership requirements and to limit the level of advances available to larger members. These changes would make it more difficult for all financial institutions to access the liquidity available through FHLBank advances, devaluing membership for existing FHLBank members, and discouraging potential members from joining. Having liquidity and competitive funding available in the FHLBank System depends upon sufficient volume. An FHLBank System made up exclusively of small members could not achieve this volume and efficiency. Likewise, even larger members cannot always get the kind of pricing available through the Home Loan Banks on their own. Simply put, such proposals would impair the ability of FHLBanks to support housing and economic development in communities across the nation.

These changes that would fundamentally alter the services that FHLBank members use to meet their community and borrower needs should not go forward. Banks like mine simply could not provide the same level of products and services to our communities without the Federal Home Loan Bank. And the Federal Home Loan Banks could not offer us the funding levels and the pricing it does without the involvement of all sizes of institutions. The FHLBank System is a true cooperative.

II. The FHLBanks Performed Exactly as Intended During the Financial Crisis

During the recent financial crisis, the FHLBanks played a critical role for bank members. As the crisis took hold and interbank lending froze, the FHLBanks were the first available source of funding for U.S. financial institutions, preventing far greater losses and potential institutional failures. As members had more need for liquidity, FHLBanks increased the availability of advances from about $650 billion at the beginning of the crisis to over $1 trillion in the peak of the crisis. That demand for liquidity receded and advances are now below pre-crisis levels. This proves the flexibility of the system and demonstrates its ability to withstand crises.

In eight decades and through several financial crises, the FHLBanks have never incurred a credit loss on an advance. This remarkable record can be attributed to the collateralization of all advances, conservative underwriting standards and strong credit

monitoring policies. Simply put, the FHLBanks met the needs of banks like mine at the time it was most required, allowing us to continue to serve our communities, even in the face of extreme difficulties.

The FHLBank System performs so well because it is structured in a way that supports flexibility. A recent Administration proposal would change that structure. A February 2011 report to Congress on reforming the housing finance system included as a potential reform for the FHLBanks to restrict each financial institution to membership in only a single FHLBank. Current law permits, with certain limitations, that an institution can be a member of more than one FHLBank. This most commonly occurs where institutions are members of adjacent districts because their businesses cross district lines, and where multi-bank holding companies maintain separate charters that focus on business in separate geographies.

The current format provides two substantial benefits to the strength of the System. First, it spreads out the advances business. Fostering a diversification of advances income is integral to the regional structure of the System. Forcing larger members to choose a single FHLBank could destabilize the System by concentrating business in a few districts and hurting access to advances in other parts of the country. Second, aligning FHLBank membership by charter location effectively diversifies risk by enabling different discrete management teams to each handle a share of the business. This diversification promotes safety and soundness, as multiple management teams are unlikely to pursue and implement the same strategies. The Administration's proposal would concentrate business, create disincentives for some lenders to maintain System membership, and create arbitrary funding deadlines – damaging changes for a cooperative that is functioning just as it was intended to, particularly in the face of economic challenges.

III. The FHLBanks' Programs Provide Assistance for the Development and Operation of Affordable Housing Developments and Collaborations

The FHLBank System, through a dependable structure and prudent financial management, is able to do even more than liquidity management. The FHLBank System also runs two important programs that provide housing and economic development for low- and moderate-income communities: the Affordable Housing Program (AHP) and the Community Investment Program (CIP).

The AHP is one of the largest private sources of grant funds for affordable housing in the United States. It is funded with 10 percent of the FHLBanks' net income each year. The AHP allows for funds to be used in combination with other programs and funding sources, like the Low-Income Housing Tax Credit. These projects serve a wide range of neighborhood needs: many are designed for seniors, the disabled, homeless families, first-time homeowners and others with limited resources. More than 726,000 housing units have been built using AHP funds, including 457,000 units for very low-income residents and the FHLBank System is the largest single funding provider to Habitat for Humanity. The total AHP contribution since 1990 is over $4.3 billion. Through the AHP, banks can fund programs that otherwise might never be carried out.

The CIP offers below-market-rate loans to banks like mine for long-term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods. The program is designed to be a catalyst for economic development because it supports projects that create and preserve jobs and help build infrastructure to support growth. Banks like mine have used CIP to fund owner-occupied and rental housing, construct roads, bridges, retail stores, sewage treatment plants and provide small business loans. The program is especially appreciated in rural areas where resources are limited. Since 1990, CIP has lent over $61 billion for a variety of projects, resulting in an estimated 200,000 jobs.

ABA believes that the changes proposed by the Administration and the regulators would have a deeply negative impact on the ability of FHLBanks to carry out these important programs. The FHLB System is strong because of the diversity of its membership. Changes to the membership rules and structure would damage the reciprocal relationship between each member, each cooperative, and the FHLBank System as a whole.

As an example, some holding companies choose to maintain separate charters for their subsidiaries in order to create closer ties with that institution's community and to maintain a local presence. One way that these institutions do so is through the AHP of their regional FHLBank. Limiting a holding company to a single FHLBank membership, as proposed by the Administration's plan, would effectively limit some members' participation in AHP in their district. This limitation would have the effect of concentrating AHP funds in some districts at the expense of others, arbitrarily punishing some members and communities while rewarding others.

Conclusion

The Federal Home Loan Bank system is not only critical to the day-to-day functioning of many community banks across the country, but plays a pivotal role in providing funding to improve low- and moderate-income communities. Proposals to improve the overall housing finance situation – through changes to Fannie Mae and Freddie Mac, and GSEs as a whole – should not make modifications to the FHLBank System. The FHLBanks have a track record of success even in the face of extreme financial challenges.

Statement of

Lee R. Gibson

Chairman, Council of Federal Home Loan Banks

Chairman, Federal Home Loan Bank of Dallas

Before the

House Financial Services Committee

Subcommittee on Oversight and Investigations

October 12, 2011

Good Afternoon Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee. My name is Lee Gibson and I am Chairman of the Council of Federal Home Loan Banks as well as Chairman of the Federal Home Loan Bank of Dallas. I am also the Chief Financial Officer and Senior Executive Vice President of Southside Bank, a $3 billion community bank with headquarters in Tyler, Texas that is a member of the Federal Home Loan Bank of Dallas. I appreciate the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks (Council), a trade association representing all twelve Federal Home Loan Banks (FHLBanks).

Federal Home Loan Bank System Overview

At the outset I would like to describe the FHLBanks and their critical role in providing cost-effective funding to members for use in housing finance and community and economic development.

The FHLBanks were created in 1932 to support America's housing finance system through their member thrift institutions and insurance companies. Since that time, Congress has expanded the mission of the FHLBanks to include support for affordable housing, community development, and other forms of community lending and has expanded eligibility for membership in the FHLBanks to commercial banks, credit unions, and community development financial institutions. Advances (fully secured loans to member institutions) represent the core of the FHLBanks' business. Members rely on the FHLBanks to provide competitive access to liquidity across all economic and credit cycles. This liquidity enhances the financial strength of local lenders so that they can meet the housing finance and credit needs of their communities through a range of products and services.

During the nation's financial crisis, when dislocations in the capital markets made funding from other sources difficult, the FHLBanks were the first available source of funding for U.S. financial institutions, preventing far greater losses and potential institutional failures. The FHLBanks were able to increase their lending to members of every asset size and in every part of the country by more than $350 billion, from a total of $650 billion in the second quarter of 2007 to over $1 trillion in the third quarter of 2008. The FHLBank System is built to be scalable - advance levels ebb and flow with credit cycles to match member demand. Since the height of the crisis, advances have declined by more than half as weak asset growth and excess liquidity have stemmed members' demand for credit. The decline in advance levels, following their rapid expansion, is further evidence that the FHLBank model works as intended.

The FHLBank System has a unique cooperative structure, comprised of twelve regional FHLBanks, their 7,795 member financial institutions, and the Office of Finance that issues debt on behalf of the twelve regional FHLBanks. The FHLBanks are overseen by an independent regulator, the Federal Housing Finance Agency (FHFA), established by the Housing and

Economic Recovery Act of 2008 (HERA Act of 2008). Each FHLBank is a separate and distinct corporate entity with its own stockholder / member institutions and its own board of directors. While the FHLBanks issue debt collectively and are jointly and severally liable for the repayment of those debt obligations, there is no single controlling corporate entity with responsibility for, or authority over, the FHLBanks. The twelve FHLBanks operate independently under the authority granted by Congress through the Federal Home Loan Bank Act, as amended, and in accordance with the regulations established by the FHFA.

The FHLBanks are cooperative institutions that operate within districts originally established by the Federal Home Loan Bank Board, one of the predecessors to the FHFA. Each FHLBank's capital stock is owned only by its member institutions. Each member must purchase the FHLBank's capital stock in order to become a member, and must maintain capital stock holdings sufficient to support its business activity with the FHLBank in accordance with the individual FHLBank's capital plan.

An FHLBank's capital stock cannot be issued to or held individually by members of an FHLBank's board of directors, its management, its employees, or the public, and is not publicly traded. There is no market for FHLBank capital stock other than among FHLBank members. The price of an FHLBank's capital stock cannot fluctuate, and all FHLBank capital stock must be purchased, repurchased, or transferred only at its par value. There are no stock options or other forms of stock-based compensation for FHLBank management, directors, or employees.

As cooperatives, FHLBanks are not subject to the growth imperative that often drives the decisions of publicly-traded corporations. Demand for advances expands and contracts with economic and market conditions and the FHLBanks' capital structure supports this movement. Membership requires a baseline capital contribution based on the amount of assets on the member's balance sheet. In addition, each time a member takes out an advance, it must purchase additional "activity-based" capital in proportion to the face value of that advance.

During periods of credit expansion, the cooperative structure provides additional capital to support advances growth. During periods of extreme distress, such as the recent liquidity crisis, the System's capital structure ensures adequate capitalization: as member liquidity needs increase demand for advances, the self-capitalizing nature of these borrowings enables the FHLBanks to extend credit while preserving the safety and soundness of each cooperative.

Equally important to the scalability of the System is the scalability of its infrastructure, which has expanded in recent years due to changing requirements in risk management and internal control. The wholesale nature of the business enables the System to function with a small number of staff relative to its asset size. Together with the Office of Finance, the FHLBanks' debt issuance agent, the FHLBanks employ about 3,000 persons to manage $809 billion in assets as of Q2 2011. Significant investments in information technology have made this

scale possible. Across the FHLBanks, the people, processes, and systems in place can handle varying degrees of business without incurring significant additional costs.

Having recently completed their statutory obligation under the Federal Home Loan Bank Act to make payments related to the Resolution Funding Corporation, the FHLBanks have undertaken a joint capital enhancement agreement to further strengthen their financial soundness. Each FHLBank will now, on a quarterly basis, allocate 20 percent of its net income to a separate restricted retained earnings account established by that FHLBank. Under the agreement, each FHLBank will build its separate restricted retained earnings account to an amount equal to one percent of its total outstanding consolidated obligations.

Corporate Governance of the FHLBanks: The Role of the Board of Directors

Congress established a unique ownership and governance structure for the FHLBanks, which has served the FHLBanks well in the past and continues to do so today. A critical feature of this structure is that the FHLBanks are wholly owned by their members/customers so each FHLBank's interests are simultaneously aligned with those of its members and customers. In addition, the boards of directors of the FHLBanks are truly independent of management. No member of management may serve as a director of an FHLBank.

The Federal Home Loan Bank Act provides that a majority of each FHLBank's directors must be elected by its member financial institutions from among officers and directors of those institutions. Members vote for directors representing member institutions from their states. At least two-fifths of the directors must be independent (non-member) directors. The HERA Act of 2008 altered the governance structure of the FHLBanks to provide for the election of independent directors by the FHLBanks' members, rather than their appointment by the regulator. HERA also required that at least two of each FHLBank's independent directors must represent the "public interest" by having more than four years of experience in representing consumer or community interests on banking services, credit needs, housing, or financial consumer protection. The remaining independent directors must have demonstrated knowledge or experience in financial management, auditing and accounting, risk management practices, derivatives, project development, organizational management, or such other expertise as the FHFA Director provides by regulation.

The Federal Home Loan Bank Act also provides that no member may cast a number of votes in the election of directors greater than the average number of shares all the members in its specific state are required to hold. This prevents large members holding relatively large amounts of a FHLBank's capital stock from dominating director elections and, in practice, means that the majority of each FHLBank's member directors generally represent the small institutions that make up the great majority of all members.

The statutory framework that controls the composition of the FHLBanks' boards of directors ensures that each FHLBank's board of directors will have a balance of interests represented. With no members of management on the board of directors, directors are in a position to independently oversee management actions. The members that contribute capital and benefit from the FHLBank's products and services are assured a majority of the directors. The director election voting preferences for small members ensure that larger members cannot dominate the board of directors and that a FHLBank's policies will not be detrimental to small members. Finally, the large contingent of independent directors ensures that the FHLBanks will appropriately consider their public policy obligations.

FHFA regulations require that the FHLBanks' boards of directors not only fulfill the typical corporate director duties of care and loyalty, but that they also carry out specific responsibilities. These duties include, but are not limited to, the responsibility to select and oversee management, the responsibility to ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, and a member products policy that details the Bank's credit and pricing policies, and the responsibility to approve the FHLBank's annual operating budget and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. FHFA 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, human resources and housing program oversight functions. The various elements of the FHLBanks' corporate governance structure combine to provide boards of directors that are active, knowledgeable, and engaged, and that are fully aware of their responsibilities and take them seriously.

FHLBank Advances and Member Services

In accordance with statutory requirements, all advances are secured by eligible collateral and the purchase of capital stock. When FHLBanks issue advances, they lend against both the credit of the member-borrower and the quality of the collateral. Each FHLBank establishes its own processes and procedures for assessing these characteristics based on its understanding of the markets. Credit monitoring, for example, considers microeconomic trends and local laws and regulations. This is accomplished through data collection, financial analysis, and substantive interaction with members' management teams.

Each FHLBank's collateral team establishes the lendable value of a members' assets through site reviews, loan level pricing, and future exposure discounting. Review teams need to

understand and consider regional variations in order to assess the risk profile and value of collateral. For example, some markets are dominated by larger commercial banks where others are primarily served by community financial institutions. Some markets display a concentration of loans exceeding the conforming loan limits, where others are well within the limits. On the coasts, there is a higher concentration of commercial real estate lending, and in the midwest some institutions specialize in agricultural lending.

The valuation and management of member collateral is a process that relies on regional expertise and market knowledge. During a time when many institutions attempted to streamline or outsource credit underwriting and collateral evaluation processes, the FHLBanks stuck to the basics and combined conservative collateral valuation practices with effective credit policies. The System has an impressive track record as a result.

Beyond assessments and risk management, a variety of member services, such as correspondent services, leverage local knowledge to deliver value. While these services vary across the System, it is clear that the strong relationships between FHLBanks and their members are mutually-beneficial and integral to the strength of each cooperative.

FHLBank Mortgage Purchase Programs

The System has an excellent track record of working with members to manage risk in the mortgage purchase programs that some FHLBanks have administered for the last decade. In these programs, a participating FHLBank purchases traditional prime single-family mortgages originated by member institutions under a risk-sharing agreement between the FHLBank and the member. The collective portfolio of mortgage loans carries a 4.16% delinquency rate in comparison to a 7.05% delinquency rate for all prime loans nationwide. Total actual credit losses from mortgage investments since the program's inception in 1997 have been approximately 3 basis points of total mortgages funded.

These programs are an example of the success that can be achieved from "skin-in-the-game" mortgage partnerships. Community bankers exemplify "skin-in-the-game" business principles on a daily basis—their success is dependent upon being fully invested in the success and survival of the communities that they serve. Prudent underwriting, adequate appraisals, and the provision of appropriate credit products that suit an individual borrower's needs are fundamental operating principles for most community bankers.

FHLBank Housing and Community Lending Programs

For more than 20 years, the FHLBanks' Affordable Housing Program (AHP) has been one of the largest private sources of grant funds for affordable housing in the United States. It is funded with 10% of the FHLBanks' net income each year. These grant funds are distributed through a competitive process to projects developed through partnerships of member institutions and local developers and housing organizations. AHP grants subsidize the cost of owner-occupied housing for individuals and families with incomes at or below 80 percent of the area median income (AMI), and rental housing in which at least 20 percent of the units are reserved for households with incomes at or below 50 percent of AMI. The subsidy may be in the form of a grant or a below- cost or subsidized interest rate on an advance. AHP funds are primarily available through a competitive application program at each of the FHLBanks. AHP funds are also awarded through a homeownership set-aside program to assist low and moderate income households in purchasing homes, with at least one-third of the funds being used to assist first-time homebuyers. The AHP allows for and encourages funds to be used in combination with other programs and funding sources, such as the Low-Income Housing Tax Credit. These projects serve a wide range of neighborhood needs: many are designed for seniors, the disabled, homeless families, first-time homeowners and others with limited resources. As of year- end 2010, more than 742,000 housing units have been built using AHP funds, including 457,000 units for very low-income residents. The total AHP dollars awarded from 1990 through 2010 is approximately $4.3 billion.

Each Federal Home Loan Bank also operates a Community Investment Program (CIP) that offers below-market-rate loans to members for long-term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods. Members use CIP advances to fund the purchase, construction, rehabilitation, refinancing, or predevelopment financing of owner-occupied and rental housing for households with incomes at or below 115 percent of AMI. The program is designed to be a catalyst for economic development since it supports projects that create and preserve jobs and help build infrastructure to support growth. Lenders have used CIP to fund owner-occupied and rental housing, and to construct roads, bridges, and sewage treatment plants as well as to provide small business loans. From 1990 to 2010, the FHLBanks' CIPs have lent over $61 billion for a variety of projects, resulting in 726,000 housing units.

The FHLBanks' Community Investment Cash Advance (CICA) programs offer funding, often at below-market interest rates and for long terms, for members to use to provide financing for projects that are targeted to certain economic development activities. These include commercial, industrial, manufacturing, and social services projects, infrastructure, and public facilities and services. CICA lending is targeted to specific beneficiaries, including small businesses, and households at specified income levels.

Risk Management of the FHLBanks

As twelve independent institutions, the FHLBanks are responsible for their own risk management activities. Each FHLBank has its own risk profile and approaches management of its risks to address its risk profile. The cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk profile, and in fact discourages FHLBanks from taking excessive risk. Just as FHLBank members do not expect equity investment returns on their capital stock investment in a FHLBank, they also do not expect equity investment risk in that investment. Members purchase FHLBank capital stock in order to obtain access to FHLBank funding products, and must maintain capital stock investments in the FHLBank as long as they maintain advances outstanding. Members provide the capital that supports their advance transactions with the FHLBanks. In this environment, members expect stability, reliability and consistency of returns and credit product pricing. These member expectations are reflected in the oversight provided by each FHLBank's board of directors, a majority of which is comprised of directors representing member institutions.

In large part due to the incentives created by the FHLBanks' cooperative structure, risk aversion and conservative risk management practices are ingrained in the corporate culture. This same conservative approach to risk management is also reflected in both the legal restrictions and the FHFA's regulatory regime. For instance, the Federal Home Loan Bank Act and the FHFA's implementing regulations clearly describe and mandate the various limitations on the types of collateral the FHLBanks may accept to secure advances. Regulations limit the types, amounts and required credit ratings on both short and long term investments the FHLBanks make with surplus funds.

In addition, FHFA regulations require that each FHLBank maintain a Risk Management Policy, reviewed at least annually and re-adopted at least every three years by its board of directors, which identifies specific risk management practices and limits for the individual FHLBank. These practices and limits are monitored by the FHLBanks' internal audit departments, which report their findings directly to the FHLBanks' boards of directors. The FHFA also monitors FHLBank compliance with these and other regulatory requirements through monthly call reports, constant off-site monitoring, and annual on-site examinations.

The FHLBanks are also subject to very conservative capital requirements imposed by statute in the Gramm-Leach-Bliley Act (GLB Act) and by FHFA regulations implementing those statutory requirements. These requirements specify that FHLBanks must have total capital equal to at least 4.0 percent of their total assets, and must have sufficient permanent capital (as defined by the GLB Act) to meet a risk-based capital regime established by FHFA regulation.

The FHLBanks minimize credit risk by ensuring that advances are fully secured, that their investments are limited to issuers or securities that are highly rated at the time the investments are made, and that their mortgage purchase programs have appropriate risk-sharing

features. No FHLBank has ever suffered a credit loss on an advance to a member in the FHLBanks' history.

FHLBank Debt Issuance: Dependable Access to a Deep, Liquid Market for FHLBank Debt

The international market for FHLBank debt is one of the most liquid. To the end investor, this liquidity represents an appealing characteristic. Collectively, the FHLBanks issue debt in significant volume every day of the year. The size, frequency, and consistency of issuance mean that it takes less time for the market to absorb new issues during both normal and stressed markets. In turn, this makes it profitable for dealers to allocate capital against FHLBank underwriting and trading. Greater capital allocations, in turn, mean greater liquidity in the market.

This liquidity enables the FHLBanks to fund at attractive levels across a host of terms and structures. In turn, they pass this advantage on to their members. All members receive the benefit of attractive funding, regardless of their size. Because advances are a spread product, attractive issuance levels for FHLBank debt translates directly into lower advance prices for members. In turn, these members are able to pass these benefits on to their communities in the form of affordable credit.

Another benefit of the depth and liquidity of the market for FHLBank debt is that the System is able to rapidly scale up its issuance with member demand for advances. The FHLBank debt franchise is well-recognized and highly-desired by a host of global investors due to its liquidity and credit quality. During 2007 and 2008, against a dislocated bond market, the System was able to increase debt outstanding by $360 billion over 15 months. This added funding provided a lifeline to members across the country and undoubtedly stemmed the flow of failures. It is because of the depth and liquidity of the FHLBank debt market that the System is able to tap the markets in size when demand surges—even during extreme distress.

Issues Facing the FHLBank System

A. Any Changes to FHLBank Membership Should Be Initiated By Congress

Last year the Federal Housing Finance Agency (FHFA) published for public comment an advance notice of proposed rulemaking (ANPR) to review current FHLBank membership requirements.

In response to the ANPR the FHFA received 137 comments, the vast majority of which expressed opposition to the suggested membership changes. Among those submitting comments raising concerns over these changes - in addition to the Council and the twelve FHLBanks - were

the American Bankers Association (ABA), the Independent Community Bankers of America (ICBA), the National Association of Homebuilders (NAHB), the American Council of Life Insurers (ACLI), the National Association of Mutual Insurance Companies (NAMIC), the National Association of Federal Credit Unions (NAFCU), the Credit Union National Association (CUNA), the Mortgage Bankers Association (MBA), and a joint comment including the Financial Services Roundtable (FSR), the American Insurance Association (AIA), and the Property Casualty Insurers Association of America (PCIAA). In addition, comment letters on the ANPR were submitted by House Financial Services Chairman Spencer Bachus as well as Ranking Member Barney Frank.

Any changes to the FHLBanks' membership or mission – especially changes that would restrict membership eligibility or narrow the FHLBanks' mission - should come first from Congress. The FHFA should not proceed down a path toward fundamentally altering the FHLBank System without express Congressional guidance, especially at this time when Congress and the Administration are undertaking a top to bottom review of the housing finance system in the United States, including a review of the important role served by the FHLBanks as a provider of liquidity.

The regulatory changes being considered would make it more difficult for financial institutions to access the liquidity available through FHLBank advances and would devalue membership for existing FHLBank members and discourage potential members from joining, ultimately inhibiting the ability of FHLBanks to serve the housing and community development needs of their districts. These potential changes would be especially burdensome to small and medium sized members, at a time when these members are already subject to many other new regulatory requirements.

At a time when policymakers should be looking for ways to jump start economic activity by encouraging banks and other financial institutions to increase their lending to small businesses and other job creating activities, the changes being considered threaten to limit access to the low-cost funding provided by the FHLBanks. It is an example of the mixed messages being sent to community banks from some in Washington. Such mixed messages continue to create uncertainty and impede the economic recovery.

B. Borrowing Limits Should Not be Imposed on Members of the FHLBank System

The Administration's February 2011 report to Congress on reforming the housing finance system included, as a potential reform for the FHLBanks, limiting the level of advances for large financial institutions. Limiting the borrowing activity of large members would impair the ability of the FHLBanks to fulfill their mission of supporting housing and economic development in communities throughout their districts and could have the unintended consequences of higher costs of funds for smaller banks and for end consumers.

Large member borrowing is mission-consistent and beneficial to smaller members. The participation of large institutions in the FHLBanks strengthens the industry as a whole and enhances the value that individual FHLBanks deliver to members of all sizes; especially smaller members.

The composition of the FHLBank membership closely approximates the composition of the banking industry. As a result of membership requirements and the nature of collateralized borrowing, large institutions actually participate in housing finance to a greater extent than they participate in the FHLBank System. FHLBank participation of large members reflects their role in housing finance. At year-end 2010 the FHLBanks extended $177 billion in advances to their ten largest members, representing 38% of total advances. Collectively, these members hold over $2.5 trillion in mortgage assets and accounted for 68% of all residential mortgage originations in 2010. Against this outsized role and substantial supply of mortgage collateral, the participation of large members is both reasonable and mission-consistent.

Members use advances to fund new originations and existing portfolios of mortgages, to purchase mortgage-backed securities, and to manage the substantial interest rate risk associated with holding mortgages in portfolio. Some members layer in term advances alongside their deposits, altering the duration profile of their liabilities to better suit their assets and mitigate risks. Other members use shorter-term, on-demand liquidity to offset unexpected deposit runoff or to take advantage of an opportunity to quickly add assets. By enabling members to effectively manage their balance sheets, advances lower the cost of extending credit to American consumers.

Institutions of all sizes—from the $2 million credit union to the $1 trillion-dollar bank—benefit from equal access to liquidity through the FHLBanks.

Participation of all members strengthens the System. Not only does the housing finance market benefit from large members' access to the FHLBanks, small- and medium-sized members benefit from the participation of larger institutions in the System in three crucial ways:

- First, advances to large institutions bring with them commensurate amounts of invested capital across which to spread the impact of operating expenses on returns, which in turn allows the FHLBanks to operate on narrower interest margins and reduces the cost of credit to all members. This effect supports the costs of maintaining the risk management, internal control, and other compliance infrastructure that are critical to ensuring that the FHLBanks operate in a manner consistent with their responsibilities as GSEs.

- Second, larger volumes of advances increase the FHLBanks' income, which helps to build retained earnings cushions. In both regards, large member participation strengthens the economics of the cooperative.

- Third, advances to large members facilitate a critical mass of debt issuance which contributes to the FHLBanks' market presence. A deep, liquid market for FHLBank debt is critical to the success of the System because it enables FHLBanks to extend credit at a reasonable cost and rapidly grow or shrink with member demand. While it is impossible to quantify the market liquidity benefit, any incremental pricing discount attributable to the depth of the market is especially meaningful to small- and medium-sized institutions, which have less outside access to the capital markets.

Further, the depth of the FHLBank debt markets provides sufficient liquidity to serve all members, ensuring that smaller borrowers never get crowded out by larger ones. On the funding side, the robust market for agency debt pre-empts the need to ration credit and allows the FHLBanks to translate this increased demand into a pricing and liquidity advantage for small- and medium-sized members.

Layers of protection mitigate any incremental risks that may be posed by large borrowers. Advances are by regulatory requirement overcollateralized. Through a rigorous process, each FHLBank continually manages the pool of collateral backing an advance. This includes frequent monitoring of performance, pricing, and valuation. Members are required to maintain a sufficient pool of performing collateral, so they regularly replace delinquent loans and add collateral based on changes in haircuts and valuation. These precautions ensure sufficient overcollateralization at all times.

When an FHLBank lends to a troubled member, it does so in consultation with that member's primary regulator. In the event that the member subsequently becomes insolvent, this process enables the FDIC to minimize losses to the Deposit Insurance Fund. In a liquidation scenario, the

FDIC typically pays off outstanding advances in exchange for the timely release of collateral in an attempt to maximize the resolution value of the institution. Should the FDIC opt out of this arrangement, the FHLBank can liquidate the collateral to pay off any advances.

For an FHLBank to take a loss on an advance, the liquidation value of a member's pledged assets would have to be less than the outstanding advance plus prepayment fees (the fair value of the advance). This is extremely unlikely— since the establishment of the System in 1932, no FHLBank has taken a credit loss on an advance. In the event that collateral was insufficient to cover a defaulting member's borrowings, the next line of defense to FHLBank shareholders would be the failed member's investment in capital stock. This capital is proportional to both the size of the member and to the outstanding balance of advances. It is hard to envision a situation in which a member would lose its capital investment in an FHLBank due to the failure of another member.

From the vantage point of debt investors and taxpayers, the FHLBanks' joint and several liability structure provides additional insulation from any loss that might occur at an individual FHLBank. Even if an FHLBank suffers losses, the aggregate amount of capital stock and retained earnings on the balance sheet of the FHLBanks, collectively, would provide a deep layer of insulation from losses. The combination of the FHLBanks' cooperative structure and the multiple layers of risk mitigation provide an abundance of private capital to buffer bondholders and taxpayers from potential losses.

FHLBank governance structure guards against concentration of influence by large members. The governance and composition of FHLBank boards are engineered to prevent any single member from exerting undue influence over an FHLBank's pricing, policies, or risk management. First, 40% of all directors are independent (i.e., not affiliated with a member institution). Second, the rules for election of member directors limit the number of votes that large members can cast, effectively ensuring that smaller members are well-represented. As a result, 63% of all member directors represent institutions with less than $1 billion in assets.

While it may seem counterintuitive, the participation of large banks is a precondition for a level playing field for smaller institutions. Inhibiting large members' borrowing activity would reduce scale efficiencies across the FHLBanks, thereby increasing borrowing costs for all members and ultimately for consumers. It also may impair the FHLBanks' ability to tap the debt markets in a crisis and limit their ability to support the industry during systemic crises. Having debt that is marketable to a broad cross-section of investors is key to this ability to rapidly scale up. A consistently smaller market for FHLBank debt may cause some investors to look elsewhere for investments, decreasing the number of regular participants in the market.

Debt investors value the liquidity of agency issues almost as much as they value their credit quality. The resulting decline in the issuance scale by the FHLBank System from the absence of large member participation would negatively impact the liquidity and appeal of remaining System debt issuances. This could result in increasing the cost of FHLBank funding during a financial market crisis, the cost of advances funding to members, and, by extension, the cost of mortgage lending to home buyers and owners.

C. Limiting Holding Companies to One FHLBank Membership Would Concentrate Risk and Weaken Some Members' Ties to Affordable Housing and Their Local Communities

The Administration's February 2011 report to Congress on reforming the housing finance system also included as a potential reform for the FHLBanks the concept of allowing each financial institution to be an active member in only a single FHLBank. This proposal would impair the ability of the FHLBanks to fulfill their mission to support housing and economic development in communities throughout their districts and would have unintended consequences that are counter-productive.

Currently, FHLBank membership is tied to charters: one FHLBank membership per charter. A bank holding company— though it cannot join directly— may maintain an active FHLBank membership for each chartered entity that it operates.

The current format provides two substantial benefits to the strength of the System. First, it spreads out advances business. Fostering a diversification of advances income is integral to the regional structure of the System. Forcing larger members to choose a single FHLBank could adversely affect the System by concentrating business in a few districts. Second, aligning FHLBank membership by charter effectively diversifies risk by enabling different discrete FHLBank management teams to each handle a share of the business. This diversification promotes safety and soundness, as multiple management teams are unlikely to pursue and implement the same strategies.

The transition to single FHLBank membership would provide the opportunity for members to play FHLBanks against one another in order to secure advantages or concessions. Negotiating power would be especially strong for larger members, whose larger capital investments and advances usage can provide scalability to a cooperative. Today, this situation is mitigated by the fact that membership is neither permanent nor limited. Arbitrarily creating a deadline would erase this mitigating factor.

All in all, this policy shift would undermine the stability of the System, creating incentives that run contrary to prudent risk management.

Some holding companies choose to maintain separate charters for their subsidiaries in order to create closer ties with that institution's community and to maintain a local presence. One way that these institutions do so is through the Affordable Housing Program (AHP) of their regional FHLBank. Limiting a holding company to a single FHLBank membership would effectively limit some members' participation in AHP in their district. This would have the effect of concentrating AHP funds in some districts at the expense of others, arbitrarily punishing some members and communities while rewarding others. In addition, this action would place additional strain on each FHLBanks' affordable housing staff and resources as they are faced with managing and monitoring a growing number of out of district affordable housing projects. If this became the case, it would divert AHP funds away from the district in which they were generated and outside of the regional expertise of a particular FHLBank.

The rules that govern membership in the System have evolved over time with the mortgage markets. In their present form, these rules ensure that the FHLBanks can both help lenders to finance housing and community development and support the industry in times of crisis. Proposed changes to membership rules could weaken the mission, carrying unintended consequences. In the case of consolidating memberships at the parent level, the consequences could be less robust risk management and less productive AHP relationships.

The FHLBank System is anchored in the strength and diversity of its membership. Any changes to membership rules should preserve the reciprocal relationship between each member, each cooperative, and the System as a whole.

D. Proposed Changes in Investment Authority May Also Undermine the System's Ability to Carry Out its Mission

The Administration's February 2011 report to Congress on reforming the housing finance system included, as a potential reform for the FHLBanks, the concept of reducing and altering the composition of the FHLBanks' investment portfolios to better serve the FHLBanks' mission of providing liquidity and access to capital for insured depository institutions. These suggested reforms are unnecessary for the following reasons.

FHLBanks hold two different types of investment portfolios. The first consists of short-term liquidity investments in Fed Funds Sold and highly-rated money market instruments. The primary purpose of these investments is to provide a significant pool of liquidity to support advances demand.

The second portfolio of investments consists of longer term U.S. Government- and Agency-supported investments, mortgage-backed securities and housing finance agency bonds. These mortgage related investments are consistent with the mission of the System because they support housing finance across the nation. They can also provide pools of liquidity to support advances demand in the event that the debt markets become dislocated. During a FHLBank-specific crisis, high-quality investments could be liquefied through repurchase agreements.

Investment portfolios are central to the scalability of each cooperative. Demand for advances changes cyclically, but the fixed costs of doing business have continued to rise year after year. The primary driver behind these increases is the cost of strengthening risk management, internal control, and compliance processes, which have far outpaced inflation in recent years. Assessments paid to support the operations of the FHFA have also increased rapidly, rising 77 percent from 2006 to 2010, and 175 percent since 2001. In periods such as this one, in which demand for advances is low due to high levels of liquidity in the industry, investment portfolios bridge the gap and maintain a sufficient baseline amount of income to help cover costs and provide a reasonable return on capital.

Holdings of mortgage-backed securities are limited by the FHFA to three times capital. This limited investment universe includes securities issued by Ginnie Mae, Fannie Mae, Freddie Mac, and certain senior, credit-enhanced tranches of private securitizations. The leverage restriction effectively limits credit risk exposure and ensures that mortgage backed securities (MBS) investments do not dominate any FHLBank's balance sheet or crowd out advances lending.

As discussed, the cooperative structure of the FHLBanks does not incent excessive risk-taking. Because the par value of capital stock is fixed, and because the FHLBanks cannot offer management or directors any form of equity-based compensation, there is no pressure to deliver equity appreciation and thus less of an incentive to continually grow returns. FHLBanks have tried to invest prudently, without abusing their government sponsored enterprise (GSE) status, while providing a reasonable return on capital.

In the lead up to the crisis, the System overall maintained a buffer between its consolidated portfolio of MBS and its investable limit. Even after the regulator temporarily granted some FHLBanks the authority to invest up to six times capital in mortgage-backed securities, the System overall used its authority responsibly and stayed under the three times capital limit.

E. Basel III Liquidity

In December of last year, the Basel Committee on Bank Supervision issued a new international framework for liquidity risk measurement, standards and monitoring. This framework will be implemented in the United States through a joint rulemaking process conducted by all of the relevant banking agencies. According to research conducted by McKinsey & Co. for The Clearing House, unless modified during the rulemaking process, the Basel LCR liquidity framework, as currently calibrated, will result in a liquidity shortfall for the U.S. banking industry in excess of $1 trillion.

Financial institutions subject to the new Basel liquidity framework will be required to meet new liquidity tests. One of these tests is called the "liquidity coverage ratio" or "LCR," and a rulemaking to implement this standard is expected in the near future. The purpose of the LCR is to ensure that financial institutions hold enough liquid assets to survive a 30 day liquidity crisis. The FHLBanks agree that sufficient liquidity is necessary for the safe and sound operation of financial institutions and support the goal of the LCR. However, we also believe that some of the underlying assumptions that are used in applying the liquidity coverage ratio put U.S. firms at a competitive disadvantage. Further, they do not adequately consider the role and history of the FHLBanks as a source of liquidity.

One of the key functions of the FHLBank System is to provide a reliable source of liquidity for banks, savings associations, credit unions, community development financial institutions and insurance companies that provide housing finance and community lending for American consumers.

The System has successfully performed this function since it was established by Congress in 1932. The importance of the System in providing liquidity, even during the most adverse economic circumstances, was clearly demonstrated during the recent fiscal crisis. The FHLBanks dramatically increased their lending to member institutions in every part of the country between the second quarter of 2007 and the third quarter of 2008 (from $650 billion to $1 trillion).

However, as currently calibrated the Basel liquidity framework does not take into account the unused FHLBank advance capacity. Further, the framework would require a substantial haircut in crediting FHLBank consolidated obligations for liquidity purposes.

FHLBank consolidated obligations are highly liquid, and the market for these assets is extremely deep. Every day, on average, approximately $21.6 billion in consolidated obligations are issued by the FHLBanks.

The projected $1 trillion liquidity shortfall could be substantially reduced if unused FHLBank advance capacity were included in the liquid assert buffer. Allowing excess FHLBank capacity would reduce the shortfall by $250-400 billion. In addition, adjustments in the treatment of agency debt, including FHLBank obligations, would decrease the industry - wide liquid asset buffer shortfall by more than $450 billion. This would enable our financial institutions to devote more resources to the credit needs of our economy, rather than holding cash and Treasury instruments as a drag on their balance sheets.

Although the Basel framework does not specifically address the FHLBank System, which is unique to the United States; the Basel framework does afford each country flexibility in implementing the agreement to take into account specific national variances. Our regulators should use this rulemaking authority to ensure that that the Basel III implementation process does not impose discriminatory burdens on depository institution use of the FHLBank System and disadvantage American consumers.

Conclusion

Over their long history, the FHLBanks have played a critical role in supporting their member financial institutions' ability to meet the housing finance and credit needs of their local communities in all economic cycles and in all parts of the United States. The FHLBank cooperative model performed exceptionally well throughout one of the worst financial crisis in this nation's history, without requiring any taxpayer assistance. The FHLBanks remain economically strong today and continue to serve a vital function for their financial institution members and the communities they serve.

Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the FHLBanks. I would be happy to answer any questions you have.

STATEMENT OF BRUCE A. MORRISON

CHAIRMAN
MORRISON PUBLIC AFFAIRS GROUP

SUBMITTED TO THE
COMMITTEE ON FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OCTOBER 12, 2011

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.

Testimony of

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On behalf of the

Independent Community Bankers of America

Before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Oversight and Investigations

Hearing on

"Oversight of the Federal Home Loan Bank System"

October 12, 2011
Washington, D.C.

Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee, my name is Tim Zimmerman and I am President and CEO of Standard Bank, a $435 million asset size community bank headquartered in Monroeville, PA, and a member of the Federal Home Loan Bank of Pittsburgh. I also serve as Chairman of ICBA's Federal Home Loan Task Force. I am pleased to represent ICBA's nearly 5,000 members at today's hearing on the Federal Home Bank System.

I welcome this opportunity to share Standard Bank's experience with our Federal Home Loan Bank, which is broadly typical of community banks nationwide. The 12 regional FHLBanks are a critical resource to community banks, the vast majority of which are FHLB members and active advance users or look to the FHLBanks as a primary source of liquidity when needed. FHLBank advances play a significant role in supporting community bank mortgage, small business, and agricultural lending and in helping community banks manage the interest rate risk in their portfolios. The FHLBanks help community banks like mine compete with the too-big-to-fail banks in our markets by offering a variety of correspondent services as well.

Agricultural community banks must have access to FHLBank advances to compete with Farm Credit System lenders, the only government sponsored enterprise that offers credit at the retail level, with the advantage of direct access to low cost capital markets funding. The FHLBanks serve a vital role and must remain a strong, stable, and reliable source of funding for community banks. Their value was proven during the recent financial crisis when they continued to provide advances without disruption, while other segments of the capital markets ceased to function.

As Congress debates the future of the housing finance system, I urge you to preserve the role of the FHLBanks. The model has worked well since inception and there is no reason to tamper with it. It is also very important to maintain the distinction between the FHLBanks and Fannie Mae and Freddie Mac or their potential successors. While the FHLBanks are government sponsored enterprises, they are very different than Fannie Mae and Freddie Mac in that they have no conflict between a public mission and private ownership that drove excessive risk taking and ultimately forced Fannie Mae and Freddie Mac into conservatorship.

FHLBanks Support Role of Community Banks in the Mortgage Market

Any broad based recovery of the housing market must involve community bank mortgage lending, to which the FHLBanks lend critical support. Community banks represent approximately 20 percent of the mortgage market, but more importantly, our mortgage lending is often concentrated in the small towns and rural areas of this country, which are not effectively served by large banks.

A vibrant community banking sector makes mortgage markets everywhere more competitive, and fosters competitive interest rates and fees, better customer service, and more product choice. Community banks work closely with their customers to ensure that

they obtain the right affordable mortgage for their situation. The housing market is best served by a large and geographically-dispersed number of lenders. We all witnessed the danger and devastating fallout that resulted when mortgage lending became concentrated in a few major market players. A healthy mortgage market must have beneficial competition and avoid further consolidation and concentration.

FHLBank Advances Support Lending

ICBA member surveys show that while the FHLBanks offer a wide range of products and services, the availability of advances – or collateralized loans – is by far the most important reason why they choose to be FHLBank members. Standard Bank, for example, holds $33.2 million in advances, as of the end of August.

FHLBanks offer advances in a variety of maturities, from overnight to over 20 years, and customize terms to help their members manage interest rate risk. Community banks use advances to fund new originations and existing portfolios of mortgages and other types of loans and to manage the substantial interest rate risk associated with holding longer term fixed rate loans in portfolio. Some community banks use advances to adjust the duration of their liabilities to better match their assets and manage risks. Short-term, on-demand advances can be used to provide liquidity in the event of unexpected deposit runoff or to take advantage of an opportunity to lend. Advances benefit a broad spectrum of American consumers by lowering the cost of credit.

While deposits are the most important source of funding for community banks, advances are a critical complement to deposits. During periods when loan growth outstrips deposit growth, community banks must be able to turn to advances as a dependable and convenient source of funds in order to serve their communities. Without access to advances at such times, community banks would lose market share to large banks, which are able to directly access the capital markets to raise funds. Moreover, advances can be customized to match fund the longer duration of many customer loans in a way that is not possible with checking or savings accounts or certificates of deposit. There is an ongoing need for advances to structure funding for loans.

Community Financial Institutions

Because most community banks have assets of less than $1.04 billion, they qualify as "community financial institutions" (as defined by the 1999 Gramm-Leach-Bliley Act) and therefore are eligible to pledge collateral in the form of small business loans and agriculture loans. Smaller community banks are able to use advances to meet the broad spectrum of credit needs of their communities and thereby create and sustain jobs during these challenging economic times. The broader mission of the FHLBanks is another aspect in which they differ from Fannie Mae and Freddie Mac which are focused exclusively on residential mortgage lending.

Agricultural Lending

Many agricultural bank members of ICBA report that FHLBank advances are absolutely essential for their ability to remain competitive in agricultural and agribusiness lending. In particular, long-term fixed rate agricultural real estate loans of 10 or more years would be nearly impossible for a community bank to make without the use of FHLBank advances. These loans cannot be funded with short-term deposits because of the interest rate risk that would result from the mismatch between the short-term liability and the long-term asset.

Making long-term, fixed rate loans for land, equipment, land improvement, and other purposes is important to customer retention. If a rural banker cannot meet a customer's need for a long-term fixed rate loan, the banker risks losing all of that customer's business, likely to a tax-advantaged Farm Credit System lender, or a large bank lender. The FHLBanks provide small, rural banks consistent access to affordable funds and important tools to manage interest rate risk that are available to a large bank with internal Treasury functions.

Other agricultural lenders use advances to fund their short-term agricultural production loans. As much as 50 percent of such lending during peak seasonal demand times, for some agriculturally-oriented bankers, is supported by advances. These lenders rely on advances because their liquidity can fluctuate sharply due to the seasonal credit demands of farmers, ranchers and agribusinesses. FHLBank advances help bankers meet the cyclical challenges inherent in agricultural lending and play a critical role in helping the rural economy to prosper and remain vibrant.

FHFA Proposal Would Undermine Agricultural FHLBank Members

ICBA strongly opposes a current Federal Housing Finance Agency advanced notice of proposed rulemaking that would re-impose a mortgage lending test on FHLBank members. As noted above, the 1999 Gramm-Leach-Bliley Act created the Community Finance Institution designation for institutions below a specified asset threshold (currently at $1.04 billion) and authorized them to borrow long-term advances for small business, agribusiness, and agricultural loans and pledge those loans as collateral for long-term advances. GLBA also lifted the mortgage asset test for Community Finance Institutions, which is significant for rural lenders who have few residential mortgage lending opportunities but greatly benefit from FHLBank membership. Many banks believe it is critical that they continue to be able to pledge agricultural and other non-housing collateral for advances. It's very troubling that the FHFA has now proposed to reverse by regulation Congress's removal of the asset test. The proposal cuts against the grain of Congress's clearly expressed intention of expanding the mission and role of FHLBanks beyond residential housing finance to supporting small and medium sized businesses and other critical community needs such as senior housing.

Community Banks Benefit From FHLBanks' Strong Credit Rating

The FHLBank System is able to fund advances by selling debt instruments in the world capital markets using their strong credit rating. This market access is absolutely critical to community banks' ability to compete with large banks and serve their communities. Because the debt instruments are joint obligations of the regional Home Loan Banks they carry less risk and lower interest rates. Buyers include mutual funds, commercial banks and government bodies – both in the U.S. and abroad. Broad market access is critical to the FHLBanks' financial strength and reliability.

FHLBank Model Worked During Crisis

The recent financial crisis vividly demonstrated the value of the FHLBank model. Even during the worst days of the financial crisis, FHLBank members were able to continue borrowing advances without interruption. Advances expanded dramatically during the financial crisis as many parts of the credit markets shut down. Standard Bank's advances more than doubled from $25 million at March of 2007 to $51 million at September of 2008. Thus, thousands of community banks continued to serve their customers due to the liquidity the FHLBanks provided. As the crisis abated, access to other capital market alternatives recovered and loan demand subsided, and outstanding FHLBank advances have contracted significantly. This is exactly how the model was designed to work in a crisis – scalable and expanding and contracting with the demand for credit. The financial crisis would no doubt have been worse without the existence of the FHLBank System, which provided one of the few lifelines available.

FHLBanks Offer Other Important Products and Services

Mortgage Partnership Programs

The FHLBanks also offer a residential mortgage secondary market option for their members through the Mortgage Partnership Finance and similar programs. Through these programs, members sell mortgages to their FHLBank but are also obligated to provide a credit enhancement which is typically 2 to 3 percent of the face value of the mortgage loan. The FHLBank manages the interest rate risk inherent in the long term mortgages that it purchases.

Standard Bank sells all of our fixed rate loans with a term of more than 15 years into the secondary market to avoid interest rate risk exposure. Without this option, we would not be able to make the long-term fixed rate loans our customers expect and would not be able to compete with large banks. Standard Bank used to sell such mortgages exclusively to Freddie Mac. However, recently Freddie Mac has imposed new restrictions and unfavorable pricing that has caused us to now sell exclusively to the Pittsburgh MPF. While most community banks continue to sell primarily to Fannie Mae or Freddie Mac, the MPF Programs of the various FHLBanks are an important alternative and competitive source of secondary market access.

Special Programs to Support Community Lending

Like all FHLBanks, the FHLBank of Pittsburgh offers a number of programs that help their members support their communities and offer special loan programs or loan rates that would not be possible without their assistance.

- Affordable Housing Program (AHP) – Each year the FHLBank allocates 10 percent of its net income to fund the AHP which supports projects that provide affordable housing to low income individuals. Standard Bank has sponsored two programs through this program. In 2008, using AHP funds we sponsored the Safe Harbor Home Project for $300,000; and in 2011, we sponsored the Union Mission Permanent Supportive Housing Program for $250,000. Both of these programs provide support for the homeless in Westmoreland County, Pennsylvania.
- Community Lending Program – The FHLBank provides lower cost advances (on average 20 basis points below traditional advances) based on the amount of community based loans that a bank originates. The loans must be for community and economic development projects that create housing, improve business districts and strengthen neighborhoods. Most of the loans Standard has used to obtain CLP advances are loans to small and medium sized businesses. Almost all of the Bank's $33 million of advances outstanding were done under this program.
- Banking on Business (BOB) – The FHLBank sets aside funds used to lend money to small businesses, especially start-ups that may lack sufficient equity or initial cash flow. This program assists communities in creating jobs, providing capital to underserved areas and promoting local economic growth. Standard Bank has participated in the BOB program seven times from 2005 to 2011 with total loan originations of $421,000.

  Under the BOB program the member bank must provide at least 40 percent of the total project cost. The FHLBank's BOB funds are in a second lien position behind the member and are limited to 50 percent of the member's loan.

Correspondent Services

Finally, the FHLBank of Pittsburgh's correspondent services are an added benefit of membership.

- Deposit Accounts – The FHLBank provides Standard Bank with a convenient method to settle electronic transactions such as ACH and wires as well as daily interest without having to sweep to other investment accounts.
- Electronic Funds Transfer Services – Standard Bank uses the FHLBank for foreign wires and settlement of other ACH transactions. The FHLBank is considered a

contingency back up for deposit services that the Federal Reserve provides to Standard Bank.

- Safekeeping Services – Standard Bank maintains securities at the FHLBank of Pittsburgh for which they collect and remit the monthly and quarterly principal and interest payments.

While I have used the FHLBank Pittsburgh's programs as an example, all of the FHLBanks offer comparable services though with different terms and different degrees of emphasis among them.

Future of the FHLBanks

As Congress and the Administration consider changes to the housing finance system, we urge you to preserve the significant role of the FHLBanks which helps keep community banks competitive in their mortgage, small business, and agricultural lending with the large banks and the tax-advantaged Farm Credit System. There is no reason to tamper with a model that has worked well since inception and proved its critical value during the recent crisis. The following features of the FHLBanks must be preserved:

- The FHLBanks must be kept distinct from Fannie Mae and Freddie Mac. ICBA opposes proposals to merge the FHLBank System with Fannie Mae and Freddie Mac. This is not the right solution to address the future of the two housing GSEs. While community banks have benefitted from the existing FHLBank secondary market programs, the primary business of the FHLBanks must remain advances.
- Community banks are well served by the regional nature of the FHLBanks which allows each bank to tailor its products and services to the needs of the regional economy. It is important to preserve regional FHLBanks which are better able to understand the environment in the communities their members serve, particularly the special needs of rural communities. The FHLB system is owned and governed by its members and any move towards consolidation should develop from the grass roots level, based on what members perceive to be the best operational and/or geographic structure for their district FHLB to meet their needs.
- The cooperative nature of the system also must be maintained with membership having a strong voice in governance. ICBA recognizes the need for both large and small institution membership and the benefits both bring to, and derive from, the system. The cooperative structure of the FHLBanks gives small members the same access to products and services offered to the largest members. Forty percent of all directors are independent, and the rules for election of member directors limit the number of votes that large members can cast, effectively ensuring that smaller members are well-represented. As a result, 63 percent of all member directors represent institutions with less than $1 billion in assets.

Closing

Thank you again for convening this hearing. We appreciate the opportunity to discuss the importance of the FHLBanks to community banks. While housing has been the FHLBanks historic mission focus, they now provide support to community financial institutions for a much broader range of lending and banking services. The FHLBanks proved solid and effective in supporting liquidity and housing finance through the financial meltdown. Their loss, or any changes that would impair their ability to offer low cost funding, would present a very significant challenge to community banks serving a variety of markets from coast to coast. Consumers, small businesses, agricultural borrowers, and the broader economy would feel the impact