

103

# THE FUTURE OF THE FEDERAL HOME LOAN BANK SYSTEM

Y 4. B 22/3: S. HRG. 103-902

The Future of the Federal Home Loan...RING

BEFORE THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE NEED FOR A COMPREHENSIVE LEGISLATIVE PACKAGE TO UPDATE  
AND TO STRENGTHEN THE FEDERAL HOME LOAN BANK SYSTEM'S  
MISSION, STRUCTURE, CAPITAL REQUIREMENTS, AND REGULATORY  
OVERSIGHT

JUNE 15, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



U.S. GOVERNMENT PRINTING OFFICE

86-560 CC

WASHINGTON : 1994

For sale by the U.S. Government Printing Office  
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402

ISBN 0-16-046839-6



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# CONTENTS

WEDNESDAY, JUNE 15, 1994

	Page
Opening statement of Chairman Riegler .....	1
Opening statements, comments, or prepared statements of:	
Senator D'Amato .....	2

## WITNESSES

Frank N. Newman, Under Secretary for Domestic Finance, Department of the Treasury, Washington, DC .....	3
Prepared statement .....	23
Summary .....	23
Introduction .....	23
I. Recent reports point to the need for comprehensive restructuring of the Bank System .....	24
II. Restructuring System capital should strengthen the System's long-run safety and soundness .....	27
III. Comprehensive reform is needed because of the interrelationships among the various issues .....	31
Response to written questions of Senator Murray .....	58
Nicolas P. Retsinas, Assistant Secretary for Housing, Department of Housing and Urban Development, Washington, DC .....	7
Prepared statement .....	32
Mission .....	33
Capital structure .....	34
Membership .....	35
Effects of FIRREA on Federal Home Loan Bank System .....	36
Governance and regulation .....	37
Conclusion .....	37
Response to written questions of:	
Senator D'Amato .....	59
Senator Murray .....	63
Michael T. Crowley, Jr., Chairman, Federal Home Loan Bank Stockholder Study Committee, Milwaukee, WI .....	12
Prepared statement .....	38
Introduction .....	38
Housing finance mission .....	39
Community development .....	40
Products and services .....	41
Capital: Adequacy and reform .....	41
Governance .....	42
Membership recommendations .....	42
Appendix A—Stockholder committee .....	44
Appendix B—Contacts with organizations .....	46
Mary Lee Widener, Chairman of the Board, Federal Home Loan Bank of San Francisco, San Francisco, CA .....	15
Prepared statement .....	48
I. Introduction .....	48
II. Importance of Federal Home Loan Bank System .....	48
III. The need for comprehensive reform .....	49
IV. GAO is correct: The REFCorp allocation formula is unwise public policy .....	50
V. HUD as program regulator .....	51

	Page
Mary Lee Widener, Chairman of the Board, Federal Home Loan Bank of San Francisco, San Francisco, CA—Continued	
Prepared statement—Continued	
VI. Targeted lending: AHP and CIP .....	51
VII. Membership requirements and terms of access for advances .....	52
VIII. Taxpayer exposure to the FHLB System: The issue of perma- nent capital .....	53
IX. Summary of views on HUD study .....	53
X. Conclusion .....	54
Alfred A. DelliBovi, president, Federal Home Loan Bank of New York, New York, NY .....	19
Prepared statement .....	54
Response to written questions of Senator D'Amato .....	63

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WEDNESDAY, JUNE 15, 1994

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Committee met in room 538, of the Dirksen Senate Office Building at 10:05 a.m., Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order.

Let me welcome all those in attendance this morning. We're meeting here today to consider the future of the Federal Home Loan Bank System.

I want to say, on behalf of Senator D'Amato, that he had intended to be here, but is presently engaged on a matter on the Senate Floor. If time permits, he'll be joining us. He wanted me to indicate that it was his intention to otherwise be here.

Today, we have two panels of witnesses whom we'll be hearing from. The first will be Treasury Under Secretary Frank Newman and HUD Assistant Secretary Nicolas Retsinas, who also serves as the Acting Chairperson on the Federal Housing Finance Board, the Home Loan Bank's regulator.

The second panel will include Mary Lee Widener, the chairman of the Board of Directors of the San Francisco Federal Home Loan Bank; Michael Crowley, who is Chairman of the Federal Home Loan Banks Stockholder Study Committee; and Alfred DelliBovi, who is president of the New York Federal Home Loan Bank.

The twelve Home Loan Banks were established in 1932 to help deal with that era's thrift crisis and to help assure a steady source of funding for home mortgages. Home Loan Banks, as Government-Sponsored Enterprises, are able to borrow funds in capital markets at rates close to those paid by the U.S. Treasury. They lend those funds to member institutions that put up mortgages and other housing related assets as collateral.

In the past 5 years, resolution of our more recent thrift crises brought many changes to the Home Loan Bank System. During that period, the number of thrift members, most of which are required to join, has fallen by one-third, and advances or loans to thrift members have fallen by nearly one-half. Furthermore, to help repay the costs of the thrift cleanup, legislation required the Home Loan Banks to contribute virtually all of their retained earnings,

some \$2.8 billion, plus an additional \$300 million each year. These changes clearly have been stressful to the System.

To maintain dividend levels, Home Loan Banks have expanded their traditional role to include large investments in mortgage-backed securities as a source of extra earnings. They've also widened their membership, as permitted by the 1989 thrift legislation, to include commercial banks. Bank members are now as numerous as thrift members.

Recognizing that it is time for reevaluation of the role and structure of the Home Loan Bank System, Congress, in 1992, asked for comprehensive studies by HUD, the Congressional Budget Office, the General Accounting Office, and the Federal Housing Finance Board, an especially formed committee of stockholders.

The legislation also recognized Treasury's role by asking for its comments on the studies.

The studies, of course, are now complete, and they call for wide-ranging changes in the System's membership rules, capital requirements, and regulatory structure.

Today, we have officials from both Treasury and HUD here to outline the Administration's proposal in more detail. It's fair to say that these are complicated proposals with carefully interrelated component parts.

The Administration will not be ready to offer specific legislative language within a timeframe that would enable us to act upon it this year, but I think it's important to have this hearing now, Senator, that we put in place a solid foundation for further consideration of the future of the thrift industry and the Home Loan Bank System.

With that, I'll ask unanimous consent that any statements other Members may wish to make be put into the record at this point.

#### **PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO**

Senator D'AMATO. Mr. Chairman, I want to join you in welcoming our witnesses to this hearing on the future of the Federal Home Loan Bank System. We will hear useful and interesting testimony from Administration witnesses, representatives of several Federal Home Loan Banks, and on behalf of the stockholders.

Mr. Chairman, the Federal Home Loan Bank System has been a mainstay in our Nation's housing finance system for over 60 years. While Congress has periodically reviewed and refined the role of the System, by the late 1980's it became clear that a complete analysis and comprehensive modernization of the System was necessary. Other factors underscored the need for change: the plight of the thrift industry; the need to finance the savings and loan bailout; and changes in housing finance and mortgage markets, to mention only a few. In view of these developments, Congress, in 1992, requested a number of studies to examine the Systems purpose, functions, and structure.

Mr. Chairman, these hearings serve as the backdrop for this hearing and I want to commend all of the contributors—HUD, the Federal Housing Finance Board, the GAO, the CBO, and others. They are thoughtful reports and will assist Congress in considering and determining the System's future.



Mr. Chairman, I especially want to acknowledge the participation in the hearing of Alfred A. DelliBovi, president and chief executive officer of the Federal Home Loan Bank of New York. Mr. DelliBovi has unique experience in this area. In addition to his duties at the Federal Home Loan Bank, he served as Deputy Secretary at HUD in the Bush Administration. As a result, he has a special appreciation for the role of portfolio lenders in our housing delivery system.

Mr. Chairman, although we do not have time in the current session to consider legislation to reposition the Federal Home Loan Bank System for the future, I am pleased that you have started the process with this hearing.

The CHAIRMAN. Let me now welcome our Under Secretary, Frank Newman, from the Treasury Department, and Nicolas Retsinas. We'll start with you, Mr. Newman. We'd like your statement. We'll make your full statement a part of the record, and you may summarize as you wish, then we'll go to Mr. Retsinas.

**OPENING STATEMENT OF FRANK N. NEWMAN  
UNDER SECRETARY FOR DOMESTIC FINANCE  
DEPARTMENT OF THE TREASURY, WASHINGTON, DC**

Mr. NEWMAN. Thank you, Mr. Chairman. Thank you for the opportunity to be here to present these views and for taking the initiative to lay this foundation for future action, which we believe is very important and really is called for, before the System goes much further into the future.

The reports being discussed today all show that the Bank System remains a healthy and important part of our housing finance system. They also point out the need for comprehensive updating of the System's mission, structure, capital requirements, and regulatory oversight. Together with the reports, today's hearing should help provide a map for the Administration and the Congress in developing a comprehensive legislative package. On behalf of the Administration, we look forward to introducing such a legislative proposal by early next year.

The Bank System continues to operate largely as it was initially structured, as you just noted, Mr. Chairman, and remains oriented toward depository institutions that originate and hold mortgages in their own portfolios.

It was 1989 when FIRREA introduced the first major structural changes to the Bank System by opening System membership to commercial banks and credit unions that met threshold tests for mortgage lending. Today, as you noted, more than half of all System members are commercial banks. FIRREA added two new public policy goals to the Bank System, the Affordable Housing Program and the Community Investment Program. The Act directed the Bank System to capitalize the Resolution Funding Corporation, REFCorp, and required the System to pay \$300 million a year for 40 years toward interest payments on REFCorp bonds.

The Act you just mentioned called for five studies. The reports generally conclude that the System continues to serve an important function and that it operates in a safe and sound manner. Most of the reports also urge that comprehensive changes be made to keep the System vital and healthy. Let me briefly summarize some of

the important conclusions from these reports and offer our assessment of these conclusions.

By permitting commercial banks and credit unions to join the System, FIRREA fundamentally altered the System's membership structure. All the reports agree that this particular structure of two membership classes, mandatory and voluntary, is unfair to the mandatory members and may result in differing risk-management incentives between the two groups.

We concur with the recommendations that System membership should be voluntary for all eligible members.

Consistent with that, we believe that the same rules of access should apply to all members.

Also, as recommended in the reports, we believe that membership eligibility should not be extended beyond the currently eligible group of depository institutions and insurance companies. In fact, we believe that eligibility requirements should be somewhat tighter than they are today. We agree with HUD's conclusion that member institutions should have at least 10 percent of their assets in whole residential mortgages and that this should be an on-going requirement, compared to the current rules where there's only an initial requirement and an institution might have a smaller and smaller proportion of its assets in mortgages over time and still be eligible for advances.

This raises an important concern in formulating changes to the System's mission and membership rules. We do not want to see "Home Loan" taken out of the Federal Home Loan Bank System.

We believe that the program regulator should be able to increase, but not decrease, the statutory threshold test defining an institution's commitment to housing finance in order to be eligible for System membership. A higher threshold would strengthen the nexus between membership and mortgage lending.

Finally, it's crucial that collateral rules retain their focus on mortgage loans, both to maintain the System's safety and soundness and to uphold the link between advances and housing finance. Therefore, we join in HUD's recommendation that collateral rules not be changed.

FIRREA imposed two fixed financial obligations on the System, the REFCorp obligation and the Affordable Housing Program. Taken together, they take about \$400 million a year of the System's annual earnings.

The problems with the fixed nature of these obligations are well documented in the reports. We believe the overall strength of the System would be improved by altering the internal allocation of the REFCorp obligation. Therefore, we're looking at the possibility of altering the current formula as part of the overall structural reform package.

Treasury is also concerned with the added risks being undertaken by Federal Home Loan Banks in order to meet these fixed obligations, especially the reliance on a large portfolio of mortgage-backed securities to generate the earnings needed to satisfy these payments, as well as to pay dividends to members. While we appreciate the earnings pressure created by these obligations, we are disturbed by the arbitrage between one type of a GSE security and another GSE security.

At a minimum, we believe that such investments should continue to be subject to strict limits established by the safety and soundness regulator. It should not be permitted beyond the level dictated by the earnings required from the fixed obligations. We also note that this kind of an activity does not add to the overall pool of funds financing home mortgages and transfers interest rate risk from the private sector market to a Government-Sponsored Enterprise.

Turning now to capital, as the reports note, the Bank System, as a whole, may well have more capital than it needs, given its current risk profile, but it also has the unusual characteristic that its capital lacks permanence. Voluntary members may elect to leave the System and redeem their capital stock.

The basic goal in establishing a regulatory capital structure for the System is to ensure that taxpayers are protected from any losses incurred by the System and from any problems that might arise from a shrinking membership base. The second goal is to preserve the System's cooperative nature, and the third is to promote the economic efficiency of System operations.

While the five reports offer a number of approaches to restructuring Bank System capital, there is general agreement among them as to the basic risks undertaken by the Federal Home Loan Banks. First, credit risk associated with collateralized advances is minimal.

A relatively new area of credit risk exposure for the System, however, is in off-balance sheet activities. As the System relies increasingly on structured debt financing, it incurs credit risks in the derivative transactions that are integral to such financing.

Home Loan Banks incur interest rate risk in both the advances they make and the investments they hold. Finally, as with any financial institution, operations risks are also important.

The reports each suggest that the Home Loan Bank capital requirements be restructured in some way. In general, there's been a call for more permanence in the capital base and a closer connection between risk-taking and required capital.

Rather than describe all the merits and limitations associated with the various capital proposals, I would like to voice the Treasury's concerns about problems that would be presented if publicly traded stock were issued by the Bank System. Then I would like to outline the Treasury's thoughts on appropriate capital structure.

We have a number of concerns with any capital restructuring proposal that calls for publicly traded stock in the System. Perhaps the most significant concern is how publicly traded stock would change the incentives underlying bank management. Moving to publicly traded stock would mean that the System would be expected to pay explicit returns to shareholders, which would be in the form of dividends and stock price appreciation. Currently, however, System members receive substantial implicit returns in addition to the explicit dividends paid on their redeemable stock. Without the ability to benefit from these implicit returns, public shareholders might encourage the banks to accept greater risks in an attempt to increase profits. Generally, public shareholders might encourage the banks to maximize any subsidy that's inherent in their Government-Sponsored Enterprise status, which would run counter

to the public policy interests of keeping the System low-risk and focused on specific types of financing that support the public interest.

Many of the capital structure proposals are actually refinements of the existing structure. A strong yet flexible capital structure can be developed simply by strengthening the existing capital's permanence combined with a more rational risk-based approach for setting the required level.

Permanent capital, as we use it here, means ensuring that there is sufficient time resiliency to redeemable member stock so that it is unlikely that too much capital would drain out of the System as members shrink or withdraw. As noted earlier, the basic goal for the Government is for capital to be sufficient, at a minimum, to protect taxpayers and ensure payment of the fixed FIRREA obligations. This can be accomplished by retaining the existing redeemable common stock structure but by making that redemption subject to more stringent conditions than exist today.

With clearly defined rules governing redemptions, including prompt corrective action rules, members should be otherwise free to enter and leave the System.

It is also important to select an appropriate formula for determining the minimum amount of capital for each Home Loan Bank. The Banks should have sufficient capital to ensure payment of the fixed FIRREA obligations and to avoid any direct or indirect taxpayer expense. This suggests that a minimum capital requirement should be equal to the present value of the REFCorp obligation plus some risk-based amount. The risk-based amount could be constructed as the sum of two elements; one for credit risk, both on- and off-balance sheet, as well as management and operations risks, and the other element for interest rate risk.

Establishing and enforcing capital rules requires a safety and soundness regulator, obviously.

Most of the reports describe the problems associated with the Finance Board's conflicting roles as governor-manager for the System, safety and soundness regulator, and programmatic regulator.

We agree that the Finance Board's current responsibilities are in conflict. We further believe that it is essential that the Bank System have a strong, independent safety and soundness regulator, able to handle the kind of sophisticated transactions that the Banks are increasingly getting into, to implement the regulatory reforms of the Bank System that will be part of the comprehensive reform package.

In conclusion, the five reports on the System, mandated by the Act, point the direction for comprehensive reform and updating of the System. It is important to note that in the broad areas I've described this morning, there is general agreement across the five reports. We think this is good news, Mr. Chairman, for it suggests that a consensus on comprehensive reform is achievable.

To summarize, the reports generally agree that:

- Membership rules should be made consistent for all eligible members.
- The Bank System should be able to continue meeting its FIRREA obligations, although the burden of those obligations is adding risk to the System and has certain perverse incentives.

- The Bank System capital needs to be restructured with greater permanence. The capital levels should be risk-based.
- The current responsibilities of the Finance Board, to be both manager and regulator, need to be separated.

The Treasury Department concurs with each of these conclusions.

The reports also agree on one other key point. That is, that achieving these changes and improvements to the Bank System requires comprehensive, not piecemeal, legislation. For example, moving all savings associations from mandatory to voluntary membership status must be done in conjunction with reforming the System's capital structure and membership rules.

Mr. Chairman, with the release of the final mandated study of the Bank System by HUD, the Treasury Department is working with HUD and others in the Administration to develop such a comprehensive package. As noted earlier, we expect to complete our work by this fall, and present the legislative proposal by early next year. We look forward to working with this Committee for the passage of Bank System reform legislation during the next year.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. Retsinas, we'll make your statement a part of the record, and we'd like your comments now.

**OPENING STATEMENT OF NICOLAS P. RETSINAS  
ASSISTANT SECRETARY FOR HOUSING, DEPARTMENT OF  
HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC**

Mr. RETSINAS. Thank you, Mr. Chairman. Let me join my colleague, Under Secretary Newman, in thanking you for the opportunity to come here and for your leadership on what is a very, very important issue.

As you noted, I come here in two capacities; one as the Assistant Secretary for Housing in the Department of Housing and Urban Development, and also as the designated representative of Secretary Cisneros on the Federal Housing Finance Board.

I would like to acknowledge, if I could, Mr. Chairman, the other Director of the Federal Housing Finance Board, Larry Costiglio, who's also here this morning.

I have prepared and submitted to your office, to your staff, the written statement.

What I would like to do, if I could, Mr. Chairman, is summarize the major points, summarize the study undertaken by the Department of Housing and Urban Development that I believe will lay the kind of foundation that Under Secretary Newman was referring to. As you know, the legislation asked each of the study entities to answer 14 questions. Rather than go through the 14 questions, I'd like to focus on six that I think are the core issues as you look to the future of the Federal Home Loan Bank System.

As you pointed out in your opening statement, the System was created in 1932. It was one of many agencies created, at that time, to help take this country out of the Depression. Its primary mission, in 1932, was to support housing finance. The first and essential conclusion of the HUD study is that mission ought to be

reaffirmed. That mission ought to be reaffirmed and codified. There remains an important role in the support of housing finance.

We further believe that mission can be prudently expanded. While continuing to focus on housing finance, we think it's appropriate to contemplate an expansion of that mission with new development lending. We qualify that, of course, to note that that mission ought to be expanded in a safe and sound manner, but we believe the capacity of the member institutions can add real value to community development lending.

In looking at the mission and role of the Federal Home Loan Bank System, one of the first questions that we address is the continuing importance of portfolio lending. As you know, Mr. Chairman, better than anyone, there has been a substantial growth in the role of the secondary market in housing finance and mortgage lending generally, so it is a fair question to ask what role continues to exist for portfolio lending. We believe there is an important role, and we believe that the Federal Home Loan Bank System can provide an important source of capital for that role. It is the 4,600 member institutions who are very often closest to the needs within their communities.

With my capacity at HUD, I understand that there are certain kinds of loans and certain kinds of lending that do not lend themselves to the secondary market. Multifamily lending and small business loans come to mind. It appears to us that portfolio lending is an important way of addressing those needs.

Again, our first conclusion is a reaffirmation of the mission of supporting housing finance, and a prudent expansion of that mission into community development lending.

Clearly, as Under Secretary Newman noted, the second issue that we addressed that is fundamental to the future of the System is the issue of capital and the need for an appropriate amount and type of capital to support and undergird the System. While we believe there appears to be, at least under current rules, an adequate amount of capital, we too, are concerned about the lack of a permanent capital base. We suggest, in the report, alternative ways of crafting a capital structure that will attend to that issue.

I might note that the individual banks and the regional banks are now undertaking a major study in this regard. We expect that study to be completed by the end of the summer, and that will be an input into these deliberations. We need to look not only at the capital structure as outlined by the participants, but also the appropriate capital structure that can protect the fiduciary interests that we have a responsibility for. We certainly have an open mind on what some of those alternatives may be. We will come to a conclusion when we present our legislation to you early next year.

The capital structure, of course, is related to many other issues. Another one that I want to bring to your attention is the issue of membership. If you believe, as we do, that the System is ultimately dependent on its ability to attract and retain private capital, we believe that over time membership must be voluntary. If there is going to be an efficient investment of capital, the membership ought to be voluntary and open, on equal terms to all members. We are proposing that as our conclusion. We are aware, however, of the transitional nature of that recommendation.

There are, as Under Secretary Newman pointed out, obligations of the System, obligations as it relates to the REFCorp payment, and obligations as it relates to the Affordable Housing Program. We believe those are obligations that must be met. As we make this transition to a full voluntary system, we need to make sure we don't undermine those commitments and those obligations.

The fourth conclusion of that report is the need to expand the products and services offered by the System. While we stop well short and suggest that it is not an appropriate role for the System to engage in securitizing loans and being another secondary market, we think there are some opportunities for an expanded role. I believe that many of these expanded products and services can take place without legislation. We have certainly challenged the regional banks to think through how they can reach out and be more actively supporting of housing finance and community development lending.

I have not yet received a complete report on their activities, but some preliminary information indicates there is a fair amount of imagination and creativity. We need to make sure that that's done prudently but in a way that's responsive to local needs.

The fifth major issue I would like to summarize for you, Mr. Chairman, is the issue of System governance and regulation. As you know, currently the System has three obligations. It has a safety and soundness regulatory responsibility. Second, it has what we would call a program regulation responsibility to ensure that its mission is kept, and third, it has a responsibility to oversee the business operations, the raising of capital for the System. We believe that the continued marriage and joining together of those responsibilities is inhibiting the growth, development, and potential of that System. Therefore, our report recommends a separation of those responsibilities in this way.

We would suggest that consideration be given to the delegation of the safety and soundness regulatory responsibility to the new Office of Federal Housing Enterprise Oversight.

As you know, Mr. Chairman, this was an office created by this Committee and the Congress as an independent office within the Department of Housing and Urban Development. We believe it's appropriate to have a centralized GSE regulator, and we believe this would be an appropriate home. We do, however, in the report, acknowledge this office is literally just getting off the ground. It is just in its first year and we certainly need to look at that closely to judge its capacity to carry out that responsibility.

As it relates to program regulation, that is, to ensure that the housing mission is undertaken, we suggest that we follow the model of this Congress in its regulation of the GSE's. Therefore, we are recommending, for your consideration, that the program regulatory responsibility be transferred to the Secretary of the Department of Housing and Urban Development, not the operation of its housing mission, but really oversight to ensure that mission is being met.

Third, as it relates to business operations, we believe that there can be a continuing decentralization of business operations to those that are putting up the capital. We think there is a continued role for a Federal Housing Finance Board by defining its board and

overseeing those business operations, but we believe a continuing decentralization to the level that is closest to where the money comes from is an appropriate way to move forward.

The sixth issue I'd like to bring to your attention is the REFCorp obligation. We, too, join the concern of Treasury in terms of the impact of this obligation and the kinds of investments that result as a consequence of this obligation.

In all candor, Mr. Chairman, we wrestled with an alternative way to meet that obligation. Our preliminary conclusion is that we haven't found it yet. That doesn't mean that we're still not working on it. We believe it's an important obligation, one that cannot be put aside. It does have some unintended results as it relates to the investment decisions of member banks. We're trying to find a way that we can eliminate the unintended results and still meet that obligation. We have some thoughts, some preliminary thoughts, but we've not been able to get through the budget scoring system here in a way that's able to give you, at this point, a clear recommendation.

Last, the issue of System consolidation. While we believe that, over time, there may in fact be consolidation of the System, there may be a more efficient array of the member banks, we believe it is inappropriate for us, for we here in Washington, to try to align that System. We think that if we make the System responsive to a capital structure that encourages the efficient use of capital, the System will align itself in a voluntary way, over time, in a way that's efficient and effective.

In summary, Mr. Chairman, we believe the System continues to have value. We believe the System, today, is safe and sound. We also believe it is our obligation to take those steps that are necessary to ensure its safety and soundness in the carrying on of its mission over time.

We certainly are looking forward to working with Treasury and other parts of the Administration in putting together comprehensive legislation, that we can bring to the Committee's attention next year, that we believe will set the ground work for the future safety and soundness of the System.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Let me pose this question to both of you. Right now, as you know, we're in conference with the House on the Community Development Financial Institutions Bill. I've taken the position that we should not deal with amendments to the Home Loan Bank System until we have a comprehensive proposal from the Administration.

I particularly oppose raising, from 30 percent to 40 percent, the maximum principal share of Home Loan Bank advances to members who do not meet qualified thrift lender tests.

I'm wondering, what is the Administration's position on these issues? Let me ask you first, Mr. Newman.

Mr. NEWMAN. Fine, Mr. Chairman.

We agree with you wholeheartedly. As a matter of fact, we wonder if there may be some misunderstanding about the facts here because, after taking a closer look, it turns out that only about 8 percent of that 30 percent is being utilized at the moment.



The definition does not apply to commercial banks, which are 16 percent, but to non-QTL members, as you mentioned, and that's only 8 percent, so there's quite a bit of leeway already left in the 30 percent.

Some people are also under the misimpression that the 30 percent applies to each individual bank, and that's not correct either. It applies to the System as a whole, so there just isn't any need to do it.

Second, these members that we're talking about are members who would be voluntary members. To increase the risk of the System without having a solution to the permanence of the capital just doesn't make sense from the Government's perspective. We have to keep in mind that the only way that these institutions are able to provide low-cost financing is by capitalizing on their status as a Government-Sponsored Enterprise, and there is implicit or explicit risk to the Government involved here, especially if we undertake to increase the risk without first assuring that the capital structure is proper. We've been through that before, Mr. Chairman. You know all about that. You've had to solve problems after that has happened in similar environments.

The third thing is that to start picking on pieces of this without seeing all the pieces fit together—as you suggested, it just doesn't make sense. There's a great danger of one piece or another seeming like it makes sense independently, which this one doesn't, I don't believe, but when you look at the context of everything, you then conclude that it doesn't make sense to do one piece at a time.

Mr. RETSINAS. We agree with that conclusion.

Just for emphasis, there is—one of the things that we learned, in undertaking our study—there is a Rubik's Cube quality to the System in terms of the interrelationships of the pieces. We believe it is appropriate to look at it comprehensively, so we concur with that.

The CHAIRMAN. Let me ask you, another provision in the House CDFI Bill would exempt Community Investment Program loans from existing collateral requirements of Home Loan Banks. Questions of timing aside, do you think it's necessary or desirable to eliminate collateral restrictions for these loans?

Mr. NEWMAN. Again, Mr. Retsinas will comment from some more direct experience, but our view is that it's not necessary, there's no demonstrated need for that. The collateral system is working quite well. It is essential that this System, in order to provide its fundamental function in the future, continue to be low-risk, and we need to be very careful about taking on new risks. The System is providing important community services right now without taking on undue risk, and should be able to continue to do so.

Mr. RETSINAS. Mr. Chairman, prior to my joining the Administration, I was with a housing finance agency that was a borrower from Federal Home Loan Bank System, so I am certainly aware of the collateral requirements. While they are appropriately stringent, the key word is appropriately. Right now, the collateral requirements are really a fundamental back-up of the safety and soundness of the System.

The CHAIRMAN. Mr. Newman, let me ask you this. It's our understanding that the RTC spending on thrift losses is coming in on the

low side of the expectations, at least thus far, and that sounds like good news. Some are suggesting that, as a result, we should reduce the amount of money we made available to the RTC last year. Would you agree with that? What would be your view?

Mr. NEWMAN. The first thing that occurs to me, Mr. Chairman, is when will we ever learn.

The one thing that we know in common about all the estimates that have ever been made about the costs associated with this is that they've all been wrong. One of the reasons the structure that was put in the bill, that I know you supported, was put there was to allow some degree of reality to the estimation process.

These estimates that are being talked about now are just that; they're only estimates. There's still about \$50 billion worth of problem assets that need to be sold out of the RTC. Nobody knows for sure what prices they will bring, and nobody will know until the sales are actually made.

The structure now calls for none of that \$18 billion to be spent unless it needs to be spent. There is an approval structure, where the RTC goes to the Oversight Board, that is chaired by Secretary Bentsen, any time it believes that it needs another block of funds and demonstrates, to the satisfaction of that Board, that, in fact, it needs the block of funds.

We would be delighted, and I know Secretary Bentsen, personally, is very hopeful that we'll be able to report back to the public at the end of the RTC that, in fact, much less than the \$18 billion was needed, but it would be highly premature and unnecessary to take an action at this point in time. We would hate to see the RTC in a situation where, once again, it has to come back to Congress for more funds, and the mechanism to make sure that it doesn't spend more than it needs to is already in place.

The CHAIRMAN. Very good.

Gentlemen, we have other questions for the record that we're going to ask you to respond to, and there'll be questions from other Members as well, but I'm going to excuse you now and call our next panel. Thank you very much for your testimony.

Mr. NEWMAN. Thank you.

The CHAIRMAN. Let me again introduce our witnesses on the second panel. Mr. Michael Crowley is the Chairman of the Federal Home Loan Banks Stockholder Study Committee, Mary Lee Widener is chairman of the Board of Directors of the Federal Home Loan Bank of San Francisco, and Alfred DelliBovi is serving as the president of the Federal Home Loan Bank of New York.

We'll put your full statements in the record, and we'll take you in the order that I've just cited your names, if we may.

Mr. Crowley, we're going to start with you, and we'd like you to summarize. We'll go right on down the table.

Thank you.

**OPENING STATEMENT OF MICHAEL T. CROWLEY, JR.  
CHAIRMAN, FEDERAL HOME LOAN BANK STOCKHOLDER  
STUDY COMMITTEE, MILWAUKEE, WI**

Mr. CROWLEY. Thank you, Chairman Riegle. Members of the Committee, on behalf of the Federal Home Loan Banks Stockholder Study Committee, of which I am Chairman, I'd like to thank you

for this opportunity to testify on our views of the Federal Home Loan Bank System. My name is Mike Crowley and I'm the president of Mutual Savings Bank of Milwaukee, WI.

The original request from Congress in the Housing and Community Development Act of 1992 for a report on the Federal Home Loan Bank System and its stockholders provided representatives of the System's owners with a unique opportunity to assess and debate the structure of the System and reach a consensus on the future evolution of the System.

Congress, as we've heard, has now received the full complement of reports on the Bank System, including the recently filed report from the Department of Housing and Urban Development. Although others will contribute to the assessment of the Bank System, no other group has our perspective interest and commitment to the Bank System. The stockholders of the Federal Home Loan Banks are the owners, members, and users of the System. Their Federal Home Loan Bank membership is an integral part of their institution's operations.

As we've heard and seen in the reports, no, the System is not broke, and yes, it does need some fixing, but those repairs do not have to be done on an emergency basis.

We join with the Administration in opposing the piecemeal changes to the Federal Home Loan Bank Act that would be affected by sections 220, 221, and 222 of the House version of the Community Development Financial Institutions Bill, H.R. 3474. Savings institutions, such as my own, hold about 75 percent of the stock of the Federal Home Loan Banks. We have the greatest stake in their health and are vigorously opposed to tinkering with the highly interrelated mechanism that is the Federal Home Loan Bank Act to satisfy special constituencies in advance of comprehensive reform.

The areas of the mission of the System and products and services, I believe, were well covered in the written statements that were provided by others here today. I'm going to just ask that my comments be referred to in my written statement.

I would like to point out that our group also studied the relative affordable housing contribution of each of the housing sector Government-Sponsored Enterprises. We note that the Bank System is the only one of three with an objective dollar subsidy requirement soon to reach \$100 million per year. Both Fannie Mae and Freddie Mac have specific targets for low-, moderate-, and central-city lending. They expect to show a profit margin on those loans that is not significantly different from the rest of their book of business.

The hard dollar financial commitment of the Federal Home Loan Banks and their members to affordable housing is already in place. Thus, the goals established for those other GSE's are not relevant to the Federal Home Loan Banks.

Our position on these issues was developed while Congress was in the very early stages of drafting the important CDFI legislation. We support the thrust of this legislation. I'd also like to, personally, add a thank you to Congress for the inclusion of a measure of regulatory relief within that pending legislation.

The application of formal percentages of low- to moderate-income mortgage loans, or other designated assets, against Federal Home

Loan Bank advances outstanding can never be a workable approach to ensuring appropriate use of those funds. Many institutions are occasional borrowers from the System, but their commitment of funds to these uses is ongoing, stable, and even increasing. The Community Support regulations and the CRA process is better suited to assure mission fulfillment.

Today, I've heard the Treasury's testimony with great interest, and I'm sure the System stockholders will consider it very carefully.

The question of System capitalization is a complicated one, given the twin constraints of REFCorp and the AHP. They need not, and underline the word not, drive away voluntary members through low dividends or otherwise. The Administration and Congress thus should proceed very cautiously and deliberately in this capital area, and not attempt to get too specific too quickly lest unintended and damaging consequences occur. The current work of the Federal Home Loan Bank System's Capital Study Task Force, in studying and developing recommendations on capitalization, certainly will be very important in determining how we proceed.

It is my hope that your Committee will hold future hearings that will focus on the results of the Capital Study Task Force and those industry groups, such as Savings and Community Bankers of America, that are developing recommendations on System reform. Involvement of the equity holders in any reconfiguration of a capital base is vital. At this point, virtually all of the capital in the System is represented by the holdings of redeemable common by the member institutions. Their reaction to any proposed overhaul will be critical to its feasibility and success.

I believe the critical component will be legislatively assuring that the System's permanent capital is not again subject to confiscation as occurred in 1989. This said, we would note, however, that the capital investment in the Bank System is higher than needed for safety and soundness purposes under any risk-assessment method. The stockholders' contribution to capital should be reduced, of course, subject to the ability of the Bank System to pay its REFCorp assessment and its Affordable Housing Program obligations.

The Stockholder Committee recommends that minimum safety and soundness capital standards for the Federal Home Loan Banks in the Bank System should be based on risk and overall financial condition, similar in purpose to the stress test developed for the other two GSE's.

Then again, even higher capital adequacy standards for the Bank System may be required from time to time to assure the ability of the System to maintain its triple A credit rating and to cover the REFCorp and the Affordable Housing obligation, as well as to provide a reasonable dividend to stockholders.

The Bank System should have the necessary tools available to address capital adequacy, including the authority to permit the Banks to issue different classes of stock to members, to build permanent capital, and to retain earnings without fear of confiscation.

Since the members are the providers of the System's entirely private capital, they deserve a serious review of their role in govern-

ance. In fact, and as we've heard today, several of the studies recommended a separation between regulation and management.

Here again, the Bank System currently is undertaking an effort system-wide to recommend and to study delegation of governance back to the individual local Federal Home Loan Bank Boards of Directors.

Voluntary membership on a uniform basis must be extended to all members of the Federal Home Loan Banks. Access to membership in the Federal Home Loan Banks should continue to be available only to thrifts, commercial banks, credit unions, and insurance companies, as under the current rules, since these are the Nation's portfolio lenders.

Consistent with uniform rules for membership, the stock purchase requirement for all members should be equalized when a single class of voluntary members is created.

The committee's recommendations were unanimous, in part because of the careful balancing of the individual items within the overall package.

To quote directly from our report:

The issues facing the Federal Home Loan Bank System are significantly inter-related and cannot be addressed in isolation. It is so important not to deal with the issues facing the System on a piecemeal approach.

We are aware that Congress is unlikely to adopt every provision in our report, or in any other report, for that matter, without some adjustment. Even so, we urge careful consideration of the connections between individual components of any package of System reform amendments.

In that regard, we commend to your attention one final and very difficult issue that hangs over the System since FIRREA. That is the inflexible first-dollar call on System earnings for the REFCorp contribution.

We are intrigued by the approach outlined in the GAO report whereby any shortfall or surplus from the 20 percent tax yield could be debited or credited to an interest bearing account to equate to the same present value burden and maintain the flexibility of the System. We did not offer that solution in our report but I have discussed it with many members of our committee, and we agreed that it would be an equitable way to restore flexibility to the System's operation.

I'd be happy to answer any questions on our study or on any other studies that have been submitted to you. Thank you for this opportunity to express our views.

The CHAIRMAN. Thank you very much.

Ms. Widener, I'll take you next.

**OPENING STATEMENT OF MARY LEE WIDENER  
CHAIRMAN OF THE BOARD, FEDERAL HOME LOAN BANK OF  
SAN FRANCISCO, SAN FRANCISCO, CA**

Ms. WIDENER. Thank you, Chairman Riegle and Members of the Committee, for inviting me to testify. My name is Mary Lee Widener, chairman of the Board of Directors of the Federal Home Loan Bank of San Francisco. I also serve as president of Neighborhood Housing Services of America. My comments will reflect views developed from both of these perspectives.

My relationship with the Federal Home Loan Bank System dates back to 1971 when I was employed to promote effective urban lending strategies, and in 1977, was appointed to be a director of the San Francisco Bank.

The Neighborhood Housing Services organizations grew out of that work. Wearing my NHS hat, thank you for your steadfast support over the years for that work.

All of this has given me an opportunity to witness the dramatic changes in housing finance in the last two decades. As we address the issue of reforming the System, I see our challenge as one of working for a consensus on changes that will ensure the long-term capacity of the entire System to support its housing mission through its service to portfolio lenders. Portfolio lenders are crucial to this country's most difficult housing and economic development needs, and play a preeminent role in fostering the work of community development organizations through the Affordable Housing Program and Community Investment Program of the Banks.

The Federal Home Loan Bank System, acting through its members, is a vital link between the financial community and the low-income neighborhoods of this country. As one example, South Central Los Angeles is a community with well-known social and economic problems, yet one with prideful volunteers and credit-worthy borrowers.

The members of the Federal Home Loan Bank are the most significant source of private financing that flows into South Central Los Angeles, originating 65 percent of all mortgage loans made there. Of this \$895 million, \$726 million went to minority applicants. Throughout California, our members' ratio of mortgage loans originated in the low-income neighborhoods of California was 50 percent higher than the ratio of all other mortgage originators in the State. This kind of lending is feasible for our members because the Federal Home Loan Bank System has accomplished its primary mission for the past 62 years: supporting lenders who make home loans.

Providing our members with liquidity from the Federal Home Loan Banks gives them an incentive to hold otherwise illiquid home mortgage loans that do not qualify for the secondary market and to be proactive in more difficult lending environments than otherwise would be feasible.

The Administration has indicated that it will submit comprehensive legislation to Congress addressing Federal Home Loan Bank issues. Comprehensive reform is needed to strengthen the System's capacity to excel in meeting its social and its financial obligations. In that regard, I believe that reform must be comprehensive, not piecemeal, in nature. As a result, we cannot support the adoption of the cluster of amendments in the House version of the Community Development Financial Institution legislation affecting the Home Loan Banks at this time, or in their current form. Such issues, however, should not be precluded from being adopted as part of a comprehensive package of reforms on capital, governance, and other issues.

The System, including community interest directors who are representatives of community development organizations, is working toward development of solutions on all these issues. The group is

the Governmental Affairs Committee of the Federal Home Loan Banks. Our objective is to speak on these issues with one diverse voice. We look forward to a continuing dialog with the Administration and Congress in arriving at the most productive actions possible.

One topic in need of attention is the current distortion of the primary mission of the Federal Home Loan Banks by the obligation to make interest payments on the bonds issued by the Resolution Funding Corporation, also known as REFCorp, and by the manner in which those payments are allocated among the Federal Home Loan Banks. The Federal Home Loan Banks are required by law to make a fixed annual REFCorp payment of \$300 million. As the Government Accounting Office has noted, this fixed obligation has caused the Federal Home Loan Banks to greatly increase their investment in mortgage-backed securities. The GAO found that this investment has increased both the interest rate risk and the management risk in the System, thereby raising the possibility that meeting the fixed obligations could conflict with the System's safety and soundness. The GAO is correct.

The GAO also states that the shortfall allocation penalizes lending and could disrupt the System. The Congressional Budget Office concludes that the REFCorp payment subverts a Federal Home Loan Bank's incentive to make advances to savings and loans, the very institutions that have capitalized the System. Both the GAO and CBO conclude that the formula penalizes the Federal Home Loan Banks for fulfilling the purpose for which they were chartered: to safely support lending, primarily through advances to its members.

Another key issue in reforming the System is the function of its regulator.

The HUD study states that safety and soundness regulation should be separated from the Federal Housing Finance Board's current managerial responsibilities. Everyone agrees on that point. We believe that the Boards of Directors of the Banks should be responsible for managing the Banks, and that the safety and soundness regulator should be responsible for examining and supervising the Banks in a manner consistent with other regulators.

Much discussion has occurred over the topic of who the regulator should be. The HUD proposal is that the Office of Federal Housing Enterprise Oversight be given responsibility for safety and soundness regulation, and that HUD be designated as the program regulator. It further leaves in place a potential governance role by the Federal Housing Finance Board. I am troubled by this possible three-party regulation of the Federal Home Loan Banks. The chairpersons of the Affordable Housing Advisory Councils have unanimously expressed similar concerns. We are opposed to the establishment of a program regulator that might confuse the efforts of local community groups to influence, through the Community Reinvestment Act process, the choices that financial institutions make in meeting the credit needs of their local communities.

Another critical issue facing the System today is its membership structure.

The GAO has stated that the System would be more stable and effective if membership were voluntary for all insured depository institutions. We agree.

Also, any reform of the stock purchase requirements should not discourage shareholders from borrowing from a bank. Members that borrow from the System are the main source of revenue for the System.

The two principles for constructing sound membership rules enunciated in the GAO study make a great deal of sense. First, the rules should equalize the benefits and burdens of membership for all members, irrespective of charter type. Second, the rules should give more control of the System to the shareholders of the Federal Home Loan Banks as an incentive for their use of the System and its growth in meeting public policy objectives.

The issue of System capital, its appropriate amount and form, is a complex matter.

We've not had time yet to analyze the proposals made by the Treasury Department today, though I have to admit I cheered throughout my quick reading of Mr. Newman's testimony.

We look forward to a continuing dialog with Treasury on redesign of the System's capital in a manner that will ensure the safety and soundness of the System while recognizing that the capital issue cannot be divorced from the REFCorp issue.

In closing, systematic reform is necessary in order to increase our efforts to help portfolio lenders, and through them, to help low-income communities. We need to attract new members and to retain our existing members. The REFCorp assessment, the membership requirements, the capital structure, and the governance structure need to be reformed.

Addressing the REFCorp issue is the most difficult challenge.

As GAO noted, Congress could change the fixed \$300 million assessment to 20 percent of System income and require the Federal Home Loan Banks to continue paying the Government past the maturity date of the REFCorp bonds if the present value of such variable payments was less than the present value under the current assessment. Although this proposal is budget neutral over the 37 or more years that payments would be made by the banks, we recognize that it may not be budget neutral over the 5-year time frame used for scoring proposed legislation, so it would require a budget waiver. It seems, however, that if ever a budget waiver would be warranted, it should be when GAO recommends it as a measure to reduce the long-term risk to the taxpayer in a manner that is, in the long run, budget neutral.

These reforms, Mr. Chairman, would enhance System strength and each bank's ability to back the efforts of citizens to improve home ownership and the quality of housing in their communities across America.

Thank you very much, and thank you for all your work on this. The CHAIRMAN. Thank you.

Mr. DelliBovi.



**OPENING STATEMENT OF ALFRED A. DELLIBOVI, PRESIDENT,  
FEDERAL HOME LOAN BANK OF NEW YORK, NEW YORK, NY**

Mr. DELLIBOVI. Good morning, Chairman Riegle. I'm Al DelliBovi, president of the Home Loan Bank of New York, and I appreciate this opportunity to appear before you to comment on this study. I also appreciate your including my full written testimony in the record, so I'll just say a few words in summary.

The New York Bank is in full agreement with the two central conclusions of the HUD study: One, that portfolio lending in support of mortgage financing is critically important; and two, that support for mortgage portfolio lenders should remain the core function of the Home Loan Bank System.

The System works well, and the HUD study tells us it is needed and, more importantly, it's not broken. While we look forward to working to develop comprehensive legislation in the future, we do remain in business today. Today, we and the local lenders that we serve should enjoy the benefits of the few legislative changes that we believe common sense and reason dictate are needed now.

To that end, the Board of Directors of the Home Loan Bank of New York has adopted a legislative agenda which is included in my full written testimony.

During deliberations on these legislative objectives and other comprehensive legislation that may be considered in the future, it is critical, we believe, to ask one question, the 15th question, if you will, that wasn't asked in the five studies. That question is: How do the portfolio lenders, with the support of the Home Loan Bank System, do their business?

These studies tell us that they do business, that they're worth having in business. The question I think that wasn't asked that needs to be answered is how do they do that business?

Portfolio lenders are in business for the long haul. They are often located in the very heart of their communities. The community lender is there to help finance a loan for his or her neighborhood. He or she is there to take deposits and offer savings accounts. They're there to cash checks, to make car loans or personal loans, and to keep valuables safe. In short, they serve to meet many of the diverse financial needs of their communities.

The ability to accept, as collateral, many types of mortgages, has enabled the Home Loan Banks to offer a unique foundation, a foundation from which local lenders can play their key role of building neighborhoods. With our flexible policies, we can lend against a wide variety of creditworthy, mortgage-related collateral. This flexibility has, in turn, enabled portfolio lenders to meet their customers' varying financial needs.

A great many of our local member lenders holding mortgages in the New York district hold them on 1-to-4 family residences, residences with a small business, maybe a health care facility or a dry goods store, attached. These types of 1-to-4 family properties typically do not fall into the standards and guidelines of the secondary mortgage agencies.

I give a number of examples in my written testimony of the kinds of businesses that I'm talking about, the kinds of houses, and the kinds of community lending that our members make, and they make everyday. These are the nonconforming loans.

Let me also point out that our community housing lenders don't just make nonconforming 1-to-4 family loans. Basic multifamily residential mortgage in this country is a key part of the business strategy of many of the members of the New York Home Loan Bank. Because of the special housing requirements of our metropolitan communities, our members have developed special expertise in multifamily lending. This is especially important in this sector of the residential market because it is so clearly underserved by the secondary market. In fact, if you look at multifamily mortgages that banks and thrifts hold in their portfolios, you'll see that they total 3½ times all of the multifamily mortgage securities outstanding. I think that's important enough for me to try to repeat in another way.

If you look at the entire amount of securitized multifamily mortgages, you will find that the commitment of thrifts and banks to multifamily lending is 3½ times as great. The ability to pledge these loans at the Federal Home Loan Banks is the major factor, I believe, in maintaining the flow of mortgage funding to this vital sector of the housing market.

Mr. Chairman, we believe this is community development lending. This is what our members do everyday. The portfolio lenders who do this kind of lending have relied on the Federal Home Loan Bank System to serve as an integral partner for over 60 years. Through our programs, we ensure a flow of capital from Wall Street to Main Street.

Without question, the Home Loan Bank System serves an important role in our economy. This fact is underscored in each of the five studies mandated by Congress in 1992. There is another important fact that all of the studies agree on as well, that is, that the System is well capitalized. This position of capital strength is reflected in the results of a special analysis to evaluate the stand-alone credit rating of the housing GSE's by Standard and Poor's.

Standard and Poor's gave the Federal Home Loan Bank System a triple A credit rating on a stand-alone basis, that is, without any implicit Government backing. The Bank System is the only housing GSE to receive this high ranking. Furthermore, the Bank System is among a handful of banking institutions in the entire world with a triple A stand-alone rating.

The CBO, the GAO, and HUD have each put forth ideas on how the basic nature of the capital in the System could be improved. To respond to these ideas, the 12 District Banks are conducting a coordinated and comprehensive analysis of the System's capital structure and possible alternatives.

The objective of this study is to recommend viable alternatives for the capital structure of the System that address the concerns of the Government regarding the permanency of capital while preserving the value of our existing shareholders' investment.

This System's study is being conducted by a committee consisting of Federal Home Loan Bank executives, thrift and commercial bank shareholders, public interest directors of the banks, and has the help of an investment banker, outside legal counsel, and accounting counsel as well. Three representatives from the Finance Board, Director Retsinas, Director Costiglio, and Acting Managing Director Fair, serve ex officio on this committee.

Because the System is well capitalized currently, and there is no danger, not even a cloud on the horizon, we should, in a measured and considered manner, thoroughly explore all options in this complicated question on the future structures of the System's capital. In my written statement, I list many of the questions that are being asked as part of that capital study.

The study's modeling and stress testing exercises are going to address the points contained in the Government studies, and will touch on the issues raised in Treasury's comments today.

The capital study is just getting underway. It should be concluded by late summer or early fall, and any decision to restructure the System's capital, prior to the completion of the System's capital study, could be unnecessarily premature because it will have been made before the options have been weighed and their ramifications understood. I was delighted to hear you say, in your opening statement, that legislation will not be submitted until the next Congress.

Mr. Chairman, let me conclude my remarks by emphasizing our eagerness to work with Congress to help ensure that the financing needs of all American home buyers are met.

We look forward to working with you, and thank you for this opportunity today.

The CHAIRMAN. Thank you all.

Let me raise a couple of matters with you, and I'm going to go right down the table in the same order, so we'll start with you, Mr. Crowley, but I'm asking all of you. Do you think that the Administration's proposals, as we heard them outlined today, can form the basis for comprehensive legislation next year?

Mr. CROWLEY. I think they certainly have all of the elements that are involved, that we've studied over the last year, and so on.

I'm sure, at this point, they aren't specific enough for all of us to understand exactly what the details might be, but I think they start at a good point in forming a platform upon which consensus could be built.

The CHAIRMAN. What's your view, Ms. Widener?

Ms. WIDENER. Yes. I was pleased with all the testimony that I heard, both from Secretary Retsinas and Mr. Newman. It's detail that we've got to work out on the capital study, and on the governance structure. I mention only those two items because I believe there is consensus that the REFCorp obligation should be changed to 20 percent of System income and that membership should be one class and voluntary.

The CHAIRMAN. Mr. DelliBovi?

Mr. DELLIBOVI. I would agree. I think we form a basis on a platform of all of these studies, including the testimony today.

The CHAIRMAN. The Community Development Financial Institutions Bill that we now have in the House/Senate Conference, the House bill, as you know, includes provisions affecting the Home Loan Bank System. What would your position be on adopting those provisions this year? Let me start, Ms. Widener, with you on that.

Ms. WIDENER. I am in total favor of comprehensive legislation. I just think it would be a mistake to do anything ahead of a comprehensive package. I support the notion of the subject areas in the bill but, again, they have to be looked at comprehensively.

Let me make one comment, for example, on the Community Development Bank accessing the banks without stock purchase requirements.

I feel that everyone should access the System on equal standards, and that if anyone can't meet those standards, then we need to do what's needed to help them meet them. It's that kind of detail that I'd like to be able to work out.

The CHAIRMAN. Mr. DelliBovi?

Mr. DELLIBOVI. We support both the Baker amendments and the comprehensive legislation. We think it's going to take a while to develop comprehensive legislation, so it's our position that passage of the Baker amendments will enhance the System's mission in a small way. Most importantly, it will provide additional time to develop comprehensive legislation in a rational manner.

The CHAIRMAN. We have some difference of opinion on that, but I think we've heard a lot of common thinking today. I think it's been a constructive discussion and I think it lays out the—Mr. Crowley, let me hear from you on that, too.

Mr. CROWLEY. I stated in my remarks that the stockholders are not in favor of any piecemeal legislation. I think, for reasons that Under Secretary Newman mentioned on specific issues in the amendment, there's good reason not to consider those issues, even in comprehensive legislation. In that regard, I'm speaking about the nature of access to the System and the collateral requirements.

As far as the issue about raising the limit on non-QTL borrowers, in a total comprehensive package, as our Stockholder Study Committee has indicated in its report, we have no objection to that. We do not see it as being a crisis right now. It's a definite issue that I think should be put on the back burner until next year.

The CHAIRMAN. Am I correct, then, in gathering from what you just said, that you think we ought to hold off on any changes now and put them in a comprehensive package?

Mr. CROWLEY. There's no question about it. Yes, I would agree.

The CHAIRMAN. That would be the view of the group that you've worked with?

Mr. CROWLEY. That's correct.

The CHAIRMAN. Again, let me thank you all. I think we've covered some good ground today. I think we now have this issue fully out on the table, with the respective points of view out there for public review and discussion.

We will have some additional questions for the record from other Members of the Committee who could not be here. Again, I thank you for your participation.

The Committee stands in recess.

[Whereupon, at 11:10 a.m., Wednesday, June 15, 1994, the Committee was adjourned, subject to call of the Chair.]

[Prepared statements and response to written questions follow:]

## PREPARED STATEMENT OF FRANK N. NEWMAN

UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY,  
WASHINGTON, DC

JUNE 15, 1994

### Summary

- The testimony discusses the Treasury's views on the findings of five reports on the Federal Home Loan Bank System mandated by the Housing and Community Development Act of 1992.
- The Treasury agrees with the reports that the System needs significant reform and that the interconnectedness of major issues involved—capital, membership, regulation and governance, mission, REFCorp—requires comprehensive, not piecemeal, legislation.
- Besides protecting taxpayers, System capital structure and capital requirements should preserve the System's cooperative nature. Capital requirements should be risk-based and easily implemented. There should be sufficient time resilience to redeemable member stock so that it is unlikely that too much capital will drain out of the System at any one time. The possibility that a member could not redeem all of its stock investment if the FHLBank were facing serious financial difficulties should provide members with a strong incentive to ensure that such conditions are avoided through prudent risk-management practices.
- Different capital options are being explored. There are a number of concerns with any capital structure that calls for publicly traded stock. Fixing the weaknesses with the System's capital structure does not necessarily require a complete overhaul of the current structure. The Administration will develop comprehensive legislation which will include capital recommendations early next year.
- The Bank System's regulator, the Federal Housing Finance Board (FHFB), currently has three sometimes conflicting responsibilities—program oversight, safety and soundness regulation, and governance. The Administration is examining how the Bank System's safety and soundness regulation can best be strengthened and how the rest of the FHFB's current responsibilities should be distributed.
- Membership in the System should be voluntary for all eligible members and membership rules should apply equally to all System members. All members should have the same incentives with regard to the System and share the benefits and obligations of membership equally. Member institutions should have at least 10 percent of their assets in whole residential mortgages to strengthen the nexus between membership and mortgage lending.
- The System's public mission should be to support mortgage lending and community development lending in a safe and sound way. The collateral requirements for advances should remain unchanged because the current collateral requirements minimize the credit risk in making advances and preserve the link between advances and mortgage lending.
- The overall strength of the Bank System could be improved by altering the internal allocation of the REFCorp obligation. With voluntary membership, equalized access to the Bank System, and restructured capital rules, a change in the allocation formula may be both appropriate and acceptable to the majority of System members.

### Introduction

Chairman Riegle, Senator D'Amato, and Members of the Committee, thank you for the opportunity to discuss the Treasury's views on the recently completed reports on the Federal Home Loan Bank System and to offer the Treasury's thoughts on developing a comprehensive legislative proposal to modernize the Bank System. We are happy that the Congress and the Administration are working together to review systematically the purposes, operations, and safeguards of the Bank System.

The reports being discussed today all show that the Bank System remains a healthy and important part of our housing finance system, yet they also point to the need for comprehensive updating of the System's mission, structure, capital requirements, and regulatory oversight. Today's hearing will be an important supplement to the reports and is the appropriate next step in the process. Together with the reports, today's hearing should help provide a map for the Administration and Congress in developing a comprehensive legislative package to update and strengthen the Bank System to keep it a vibrant source of housing credit into the 21st Century. On behalf of the Administration, the Treasury Department looks forward to introducing such a legislative proposal by early next year.

## **I. Recent Reports Point to the Need for Comprehensive Restructuring of the Bank System**

Since its inception in 1932, the Federal Home Loan Bank System has been an important source of mortgage credit for home buyers. Federal Home Loan Banks sell bonds in the securities market at rates only slightly higher than Treasury's and lend the proceeds (in the form of advances) to their thrift and bank institution owner-members, who in turn are able to lend this money to home buyers. Debt securities of the Bank System, like those of other Government-Sponsored Enterprises (GSE's), trade in the market at yields that reflect a perception of an implicit Government guarantee although no such guarantee, either expressed or implied, exists. Also, interest earned on Federal Home Loan Bank debt securities is exempt from State and local income taxes.

The housing finance market has changed dramatically since 1932. Two other housing-related GSE's, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), as well as the Government National Mortgage Corporation (Ginnie Mae) and various private firms now provide means for depository institutions to sell the mortgages they originate into the secondary market.

At the same time, the Bank System continues to operate largely as it was initially structured and it remains oriented toward depository institutions that originate and hold mortgages in their own portfolio. As of April 30, 1994, the Bank System had about \$187 billion in assets, of which \$101 billion was advances outstanding and \$83 billion was investment securities (including about \$27 billion in mortgage-backed securities).

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 introduced the first major structural changes to the Bank System by opening System membership to commercial banks and credit unions that met threshold tests for mortgage lending. As of April 30, 1994, the System had added 2,524 commercial bank members and 62 credit union members, which together with the 2,139 thrift members and 19 insurance company members brings total membership to 4,744 institutions. Thus, more than half of all System members are now commercial banks. FIRREA added two new public policy goals for the Bank System. It required each Federal Home Loan Bank to establish an Affordable Housing Program (AHP) in which the Bank makes subsidized advances and grants for qualifying affordable housing ventures. FIRREA also made the Community Investment Program (CIP) a statutory requirement in which the Banks make at-cost advances for qualifying mortgages and community development purposes. FIRREA required the Bank System, which at the time was owned primarily by savings and loan associations, to help pay for the cost of the thrift cleanup. The Act directed the Bank System to contribute \$2.5 billion of its retained earnings to capitalize the Resolution Funding Corporation (REFCorp) and required the System to pay \$300 million a year for 40 years toward interest payments on bonds issued by REFCorp. (This is known as the REFCorp obligation.)

The Housing and Community Development Act of 1992 called for five comprehensive studies of the Federal Home Loan Bank System. These studies, prepared by the Department of Housing and Urban Development (HUD), the Federal Housing Finance Board (Finance Board), the General Accounting Office (GAO), the Congressional Budget Office (CBO), and the Federal Home Loan Banks Stockholder Study Committee, provide us with an assessment of the System's current structure, including the changes made in FIRREA. The reports generally conclude that the System continues to serve an important function and that it operates in a safe and sound manner, yet most of the reports also urge that comprehensive changes be made to keep the Bank System vital and healthy. Let me briefly summarize for you some of the important conclusions from these reports and offer the Treasury's assessment of these conclusions. I will begin with the future role and structure of the Bank System, and then discuss how to ensure its continued safety and soundness.

### **A. THE BANK SYSTEM'S PUBLIC MISSION SHOULD BE TO SUPPORT MORTGAGE LENDING AND COMMUNITY DEVELOPMENT LENDING**

Most of the reports noted the lack of an explicit statement of public purpose, or mission, for the Bank System and several offered possible mission statements. There was a general consensus among the reports that the primary purpose of the Bank System should continue to be facilitating the provision of housing credit through low-risk, collateralized advances to home lenders. The HUD and Finance Board reports each recommend that this current purpose be broadened to encompass community development lending.

The Treasury Department agrees with the need for an explicit mission statement for the Bank System and endorses the statement of purpose in the HUD report:

The Federal Home Loan Bank System is a profit-making enterprise whose purpose is to support residential mortgage lending (including mortgages on housing for low- and moderate-income families), as well as community development lending, throughout the Nation, safely and soundly, primarily through a program of collateralized advances to System members. The System facilitates such lending by increasing the liquidity and improving the distribution of investment capital available through its member institutions.<sup>1</sup>

We believe that this statement of purpose affirms the important role played by the Bank System in making mortgage credit available while also recognizing the appropriate use of advances to finance community development activities for targeted areas and populations. The statement of purpose also recognizes the need for the System to be a profit-making enterprise and the fundamental need that the System operate safely and soundly. Importantly, we also strongly affirm the recommendation in the HUD report that collateral requirements remain unchanged. These requirements serve two critical purposes: (1) they serve to minimize the credit risk in making advances, and (2) they preserve the link between advances and mortgage lending.

This statement of purpose also limits the possible new products and services that could be offered by the Federal Home Loan Banks. We believe that is appropriate, since any GSE should be limited to a well-defined line of business. We concur with the conclusions reached in the reports that permitting Federal Home Loan Banks to securitize mortgages or make construction loans would be an inappropriate expansion of System activities because these activities are already established in the marketplace. Also, we generally concur with the strict criteria developed in the GAO and Stockholder Study Committee reports that could be used by the regulators to assess the appropriateness of possible new Bank System activities.

#### B. MEMBERSHIP RULES SHOULD CONSISTENTLY APPLY TO ALL SYSTEM MEMBERS

By permitting commercial banks and credit unions to join the Bank System, FIRREA fundamentally altered the System's membership structure. Prior to 1989, nearly all Federal Home Loan Bank members were required by statute or regulation to be System members. Today, over half of all System members are voluntary members; that is, they have freely chosen to join the System and, with certain limitations, they can also freely exit the System. In addition, State-chartered, Savings Association Insurance Fund (SAIF)-insured savings associations, which are currently mandatory members, will become voluntary members next April. This will leave just federally-chartered, SAIF-insured savings associations as mandatory members. All the reports agree that this particular structure of two membership classes—mandatory and voluntary—is unfair to the mandatory members and may result in differing risk-management incentives between the two groups.

We concur that System membership should be voluntary for all eligible members. Voluntary membership has several attractive features. First, it provides a clear market signal as to whether the Bank System provides economic value to its members. If the System no longer provides value, now or in the future, members would be expected to leave the System, thereby sending a clear message that this GSE may no longer be needed. Second, it gives all members the same incentives with regard to the System. Since all members could request to leave the System if their Bank began to experience financial difficulty, voluntary members would no longer be able to "put" their share of the Home Loan Bank's embedded losses to the mandatory members. Third, voluntary membership creates better incentives for Federal Home Loan Bank managers to operate their Banks efficiently and to be responsive to their member/shareholders. While important transitional issues exist with making membership fully voluntary, we believe that this change can be done in a way that actually improves the System's safety and soundness by putting all members on the same footing.

Consistent with making membership voluntary for all eligible institutions, we believe that the same rules of access should apply to all members. Membership rules should not differentiate either stock purchase requirements or access to advances based on whether or not a member satisfies the qualified thrift lender (QTL) test.

Finally, as recommended in the reports, we believe that membership eligibility should not be extended beyond the currently eligible group of depository institutions and insurance companies. In fact, we believe that eligibility requirements should be somewhat tighter than they are today. We agree with HUD's conclusion that member institutions should have at least 10 percent of their assets in whole residential

<sup>1</sup>U.S. Department of Housing and Urban Development, *Report to Congress on the Federal Home Loan Bank System*, April 19, 1994, page 21.

mortgages and that this should be an ongoing requirement that members should satisfy.

This raises an important concern in formulating changes to the System's mission and membership rules. We do not want to see "Home Loan" taken out of the Federal Home Loan Bank System. This means that the System's activities should not expand beyond housing finance and community development. It also raises the question of the linkage between advances and members' support of housing finance.

There needs to be a continual evaluation of whether the System is satisfying its public policy purpose of supporting housing finance. One test of this needs to be members' minimum commitment to housing finance. Members that satisfy the QTL test demonstrate a serious commitment to housing finance. It is less clear that a depository institution with only 10 percent of its assets in mortgages has the same relative commitment. At a minimum, we believe that the program regulator should be able to increase, but not decrease, the statutory threshold test defining an institution's commitment to housing finance in order to be eligible for System membership. A higher threshold would strengthen the nexus between membership and mortgage lending.

Finally, it is crucial that collateral rules retain their focus on mortgage loans both to maintain the System's safety and soundness and to uphold the link between advances and housing finance. Therefore, we join in HUD's recommendation that collateral rules not be changed in order to control the System's risks and preserve the System's basic orientation toward residential lending.

### C. FIXED FIRREA OBLIGATIONS IMPOSE A HEAVY FINANCIAL BURDEN ON THE FEDERAL HOME LOAN BANKS

FIRREA imposed two fixed financial obligations on the Federal Home Loan Bank System that must be considered in any assessment of the System. The REFCorp obligation, which I mentioned earlier, obligates the Bank System to pay \$300 million annually toward the cost of protecting federally-insured deposits in savings and loans that have failed over the last 5 years. This \$300 million is allocated among the 12 Home Loan Banks in two steps. First, each Bank must pay up to 20 percent of its net income. Should the total of the Banks' initial assessment be less than \$300 million, the Banks are assessed for the remainder on the basis of their outstanding advances to members with deposits insured by SAIF. The second FIRREA obligation is AHP. This year, the Bank System must pay the greater of \$75 million or 6 percent of its preceding year's income toward AHP. In 1995 and in subsequent years, the Bank System must pay the greater of \$100 million or 10 percent of its preceding year's income. Taken together, the fixed FIRREA obligations absorb \$400 million or more of the System's annual earnings.

The problems with the fixed nature of these obligations are well documented in several of the reports. The GAO report, in particular, provides a complete description of the problems associated with the fixed nature of the REFCorp and AHP obligations, and the allocation formula used to assess the REFCorp obligation.<sup>2</sup> Still, as the reports each describe, budgetary considerations impede any obvious solution to the current formulas outside of reallocating the REFCorp burden within the Bank System.

We believe the overall strength of the Bank System would be improved by altering the internal allocation of the REFCorp obligation. Therefore, we are looking at the possibility of altering the current REFCorp allocation formula as part of our overall structural reform package. That is, with voluntary membership, equalized access to the Bank System, and restructured capital rules, a change in the allocation formula may be both appropriate and acceptable to the majority of System members. For example, the 20 percent first-round assessment could be increased over time or the basis for the second-round allocation could be modified. Ideally, any such change could allow for a reduction in, or eventual phase-out of, Federal Home Loan Banks' holdings of mortgage-backed securities.

The Treasury is concerned with the added risks being undertaken by Federal Home Loan Banks in order to meet the fixed FIRREA obligations, especially the reliance on a large portfolio of investment securities (including mortgage-backed securities) to generate the earnings needed to satisfy these payments. While we appreciate the earnings pressure created by the FIRREA obligations, we are disturbed by the arbitrage between one type of GSE debt security and another GSE debt security currently taking place.

While the approaches to this arbitrage take many specific forms, a general example would be a Bank purchasing a mortgage-backed security that yields, say, 90

<sup>2</sup>U.S. General Accounting Office, *Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness*, GAO/GGD-94-38, December 8, 1993, pp. 33-48.



basis points over a comparable duration Treasury security, and funding it with a System debt security of equal duration on which the Bank pays, say, 30 basis points over a comparable Treasury security. In this relatively simple example, the Bank would earn a spread of 60 basis points. Thus, a \$5 billion investment like this could yield about \$30 million per year. However, the realized yield is likely to be different than this because market interest rate movements could have substantially different impacts on the durations of the Bank's liabilities and the mortgage-backed securities. Also, in practice, a Federal Home Loan Bank will likely fund a group of mortgage-backed securities with a group of debt securities of various maturities and other characteristics.

The primary reason a spread exists at all is the interest rate risk inherent in the mortgage-backed security, including the risk that mortgage prepayment speeds may change as interest rates change. As this risk is mitigated through various hedging strategies, the spread actually earned will fall. While the Finance Board has restrictive policies to limit the risks that may be undertaken, and the Federal Home Loan Banks each actively manage the interest rate risk embedded in their mortgage-backed securities portfolio, there are no perfect hedges in this type of activity. Therefore, at a minimum, we believe that such investments (and, in fact, the entire investment securities portfolio) should continue to be subject to strict limits established by the safety and soundness regulator and in any event should not be permitted beyond the level dictated by the earnings pressure resulting from the fixed obligations. We should also note that this activity does not add to the overall pool of funds financing home mortgage loans, and transfers interest rate risk from the private sector market to a GSE.

## II. Restructuring System Capital Should Strengthen the System's Long-Run Safety and Soundness

As the five Federal Home Loan Bank reports note, the Bank System, as a whole, may well have more capital than it needs, given its current risk profile, but it also has the unusual characteristic that its capital lacks permanence. Currently, 65 percent of System members are voluntary members, and another 8 percent of members—State-chartered savings associations—will be voluntary members beginning in April 1995. Voluntary members may elect to leave the System and redeem their capital stock upon exiting the System.

Most of the reports note that the Finance Board has conflicting responsibilities as the System's governor, safety and soundness regulator, and program regulator. Ensuring the System's long-run safety and soundness requires both an appropriate capital structure and regulatory capital requirements, and a strong, independent safety and soundness regulator.

### A. GOALS AND CRITERIA FOR RESTRUCTURING BANK SYSTEM CAPITAL

The basic goal in establishing a regulatory capital structure for the Bank System is to ensure that taxpayers are protected from any losses incurred by the System and from any problems associated with a shrinking membership base. For example, failure to make the annual REFCorp payment would likely increase taxpayer outlays. Thus, one implication of this goal is that the System must have sufficient capital to fund the assets needed to pay the fixed FIRREA obligations each year.

Besides protecting taxpayers, we believe that a second appropriate goal in establishing a capital structure and capital requirements for the Bank System is to preserve the System's cooperative nature. We believe the cooperative nature of the Bank System is worth preserving because it: (1) aligns the interests of members and shareholders because the members are the shareholders (in particular, it reduces the moral hazard problems associated with divorcing ownership risks from the benefits and obligations of borrowing advances); and (2) keeps the benefits of the Bank System that derive from its status as a GSE with housing lenders and their customers.

A third goal is to have a regulatory capital structure that promotes the economic efficiency of System operations.

Combined with these goals, we believe the following criteria should be used in assessing alternative capital structures for the Bank System:

- Capital requirements should be risk-based;
- Capital structure should allow individual Home Loan Banks to grow and shrink over time (this is especially important given the cyclical nature of the demand for advances);
- Capital structure should not impede future consolidation among Home Loan Banks; and
- A new capital structure should be easily implemented.

## B. THE REPORTS OFFER SEVERAL OPTIONS FOR RESTRUCTURING FEDERAL HOME LOAN BANK CAPITAL

While the five reports offer a number of approaches to restructuring Bank System capital, there is general agreement among them as to the basic risks undertaken by the Federal Home Loan Banks. First, credit risk is minimal. Advances are overcollateralized loans (that is, loans that are secured by a members' assets where the assets posted as security substantially exceed the value of the loan) and, beyond that, the Home Loan Banks have a priority interest in the assets of failed members. With respect to investments, the Finance Board's Financial Management Policy appears to limit the securities eligible for investment to only those with minimal credit risk.

A relatively new area of credit risk exposure for the System is in off-balance sheet activities. As the System relies increasingly on structured debt financing, it incurs credit risk in the derivatives transactions that are integral to such financing. For example, a Bank could provide a member with adjustable rate funding by issuing a fixed rate bond and entering into a swap agreement with a third party where the fixed rate cash flow is exchanged for the desired variable rate cash flow. In this example, the Bank has credit risk in that the failure of the third party could disrupt or cancel the swap agreement.

Home Loan Banks incur interest rate risk in both the advances they make and the investments they hold. Interest rate risk from advances is mitigated, but not eliminated, by prepayment penalties assessed when an advance is prepaid. With regard to investment securities, the Finance Board limits the amount of interest rate risk a Bank may undertake. However, the current capital rules are unrelated to a Bank's interest rate risk. Furthermore, the large holdings of medium- and long-term investments, particularly mortgage-backed securities, remain a concern because of the interest rate risk associated with funding such assets. Finally, as with any financial institution, management and operations risks are also important.

The reports each suggest that Home Loan Bank capital requirements be restructured in some way. This restructuring involves both the amount and type of capital required. In general, there has been a call for more permanence in the capital base and a closer connection between risk-taking and required capital. A number of alternatives were suggested including:

- Establishing a core (minimum) capital requirement equal to that set for Fannie Mae and Freddie Mac (2.5 percent of assets plus 0.45 percent of off-balance sheet obligations).
- Developing a risk-based capital requirement modeled after that used for banks and thrifts. Federal Home Loan Banks could be required to hold appropriate levels of risk-based capital, with advances weighted at 20 percent.
- Using stress tests like those being developed by the Office of Federal Housing Enterprise Oversight for Fannie Mae and Freddie Mac. Specific proposals regarding stress tests included using them to monitor interest rate risk or requiring the Banks to hold retained earnings sufficient to pass an interest rate risk stress test.<sup>3</sup>
- Issuing stock to the general public.
- Changing the weight used for Home Loan Bank stock in the bank and thrift risk-based capital requirements to that appropriate for an equity investment.

Other capital structures we have explored include establishing a permanent capital base through a required membership fee. Under another option, the Bank System could be encouraged to establish a larger permanent capital base in the form of retained earnings, while reducing the amount of redeemable capital as well as total capital. The Federal Home Loan Banks could be encouraged to retain earnings by clarifying that such earnings were the private property of the System's members with appropriate constitutional protections. Finally, we understand that the Bank System has recently formed a committee of stockholders, public interest directors, and Bank presidents to consider alternative capital structures. The committee expects to have a proposal by this fall and we look forward to considering the results of its work as well.

Rather than describe all the merits and limitations associated with each of these proposals (most of which may be found in the reports), I would like to voice the Treasury's concerns about problems that would be presented if publicly traded stock

<sup>3</sup> Because the Federal Home Loan Banks undertake minimal credit risk, a credit risk stress test may not be meaningful. See Congressional Budget Office, *The Federal Home Loan Banks in the Housing Finance System*, July 1993, p. 42-43, for an explanation of the technical difficulties in applying a credit risk stress test to the Banks.

were issued by the Bank System, then I would like to outline the Treasury's thoughts on an appropriate capital structure.

#### C. PUBLICLY TRADED STOCK COULD INTRODUCE A NUMBER OF PROBLEMS

We have a number of concerns with any capital restructuring proposal that calls for publicly traded stock in the Home Loan Bank System, whether that stock is issued on a System-wide basis or Bank-by-Bank. Perhaps the most significant concern is how publicly traded stock would change the incentives underlying Bank management. Moving to publicly traded stock would mean that the System would be expected to pay explicit returns to shareholders, which would be in the form of dividends and stock price appreciation. Currently, however, System members receive substantial implicit returns in addition to the explicit dividends paid on redeemable stock. (There is no price appreciation on redeemable stock; it is always carried at par.) The implicit returns to members include immediate access to liquidity (which permits members to maintain fewer liquid assets on their balance sheets) and structured financing. Without the ability to benefit from these implicit returns, public shareholders may encourage the Banks to accept greater risks and to seek out new activities to increase profits. Generally, public shareholders may encourage the Banks to maximize any subsidy inherent in the Banks' GSE status, which would run counter to public policy interests in keeping the System low-risk and focused on specific types of financing that support the public interest.

Publicly traded stock also may be inconsistent with most of the criteria described above for System capital. For example, publicly traded stock could make it difficult for Home Loan Banks to shrink and may inhibit consolidation if the stock is issued on a Bank-by-Bank basis. Moreover, implementing such a radical change would be very complex, especially given the fixed FIRREA obligations. It might also lead to numerous unintended consequences such as:

- The amount of publicly traded stock that could be successfully sold would depend on the market's forecast of future System income rather than the value the System has for its members. Furthermore, public ownership could give the System an incentive to stretch its powers to take on more risk and increase profits.
- If publicly traded stock were preferred stock, thereby having priority over members' common stock, then the dividends required for the preferred stock could be so high that in some Banks little or no income would be left for dividends to holders of the common stock. All the reports note the earnings strain created by the fixed FIRREA obligations; adding required dividends on preferred stock would increase the System's fixed obligations.
- If members' redeemable stock were made preferred stock, thereby having priority over the publicly traded common stock, then without additional measures to improve System income it is unclear that the Banks would be able to sell the common stock. If common stock were sold to the public, the members could conceivably exit the System, leaving the public shareholders with responsibility for the REFCorp obligation. In such a structure, shareholders would discount what they would be willing to pay for such stock.
- Publicly traded stock would change the cooperative nature of the System.

#### D. THE EXISTING CAPITAL STRUCTURE CAN BE STRENGTHENED AND CAPITAL LEVELS SET BASED ON RISK

As I have already noted, the five reports suggest a variety of possible improvements to the System's capital structure, all of which we are considering. Many of these proposals are actually refinements of the existing structure. This suggests that fixing the weaknesses with the System's capital structure does not necessarily require a complete overhaul of that structure. Rather, a strong yet flexible capital structure can be developed simply by strengthening the existing capital's permanence, combined with a more rational, risk-based approach to setting the required level of capital.

We are still working out the specifics of what changes would need to be made for such an approach and how they would be implemented. Let me outline for you some of our general thinking at this point. "Permanent" capital, as we use it, means ensuring there is sufficient time resiliency to redeemable member stock so that it is unlikely that too much capital will drain out of the System as members shrink or withdraw. As noted earlier, the basic goal for the Government is for capital to be sufficient, at a minimum, to protect taxpayers and ensure payment of the fixed FIRREA obligations. This can be accomplished by retaining the existing redeemable common stock structure but making redemption subject to more stringent conditions than exist today. The possibility that a member could not redeem all of its stock investment if its Home Loan Bank were facing serious financial difficulties should

provide members with a strong incentive to ensure that such conditions are avoided through strong risk-management practices in the Home Loan Banks.

Today, a voluntary member may withdraw from the System and, upon 6 months notice, have its Bank stock redeemed at par unless the Finance Board finds that the Bank's paid-in capital is, or is likely to be, impaired. In that event, the Finance Board may make a pro rata redemption. Additional limitations on redemption could be established. For example, a limit could be placed that did not allow capital to fall below a regulatory required level. Similarly, prompt corrective action rules could be developed that would specify limits on dividend payments and capital redemptions in specified situations. Redemptions might not take place in a lump sum, but rather could be done using two or three payouts over a fixed period, with some allowance for accelerated redemptions if a Bank sufficiently exceeds its minimum capital requirements.

With clearly defined rules governing redemptions, including prompt corrective action rules, members should be otherwise free to enter and leave the System. Provided a Home Loan Bank meets its capital requirements and related rules, there should be no further impediments to a member withdrawing from the System and redeeming its capital stock in an orderly fashion according to a predetermined schedule. Of course, transition rules would need to be carefully developed if such changes to System capital rules were introduced concurrent with the introduction of full voluntary membership. Also, we believe that the existing 10 year moratorium on rejoining the System after withdrawing from it should be retained.

It is also important to select an appropriate formula for determining the minimum amount of capital each Federal Home Loan Bank should have for regulatory purposes. The Banks should have sufficient capital to ensure payment of the fixed FIRREA obligations and to avoid any direct or indirect taxpayer expense. This suggests that a minimum capital requirement for Home Loan Banks should require capital at least equal to the present value of the REFCorp obligation plus some risk-based amount. The risk-based amount could be constructed as the sum of two elements, one element for credit risk—both on- and off-balance sheet—as well as management and operations risks, and the other element for interest rate risk.

For the first element, as suggested in several of the reports, the risk-based capital rules for commercial banks could be applied to the Home Loan Banks. Although the Home Loan Banks have minimal credit risk in the advances themselves, they have credit risk in off-balance sheet obligations and they have management and operations risks. Because of the low credit risk in Home Loan Banks, we expect that it may be possible to set this requirement slightly lower than it is set for commercial banks.

The larger measurable risk in the Bank System, and one that we believe must be carefully measured and controlled, is interest rate risk, including the interest rate risk implicit with off-balance sheet liabilities. Therefore, the second risk-based element we propose would require each Home Loan Bank to have sufficient capital to withstand significant interest rate shocks of various types. The exact approach for such stress tests and the determination of how much capital would be needed to pass them remain open questions at this time. While quite preliminary, our initial estimates suggest that current System capital is more than sufficient to meet the overall capital requirements suggested here, as long as the System's mix of assets and liabilities stays approximately as it is now and interest rate risk is adequately hedged.

While changes are needed in the statutory requirements governing System capital, the safety and soundness regulator should also be given authority to adjust the Banks' capital requirements over time. For example, the System's safety and soundness regulator should have the authority to establish minimum requirements for retained earnings.

As with any GSE, one of Treasury's primary concerns is the GSE's safety and soundness. We believe that the steps outlined here can strengthen System capital, make the level of required capital sensitive to the amount of risk undertaken by a Bank, continue to give member/shareholders a strong incentive to control risk-taking by Bank management, and make System membership economically beneficial for depositories that have a focus on home mortgage lending.

#### **E. STRONG, INDEPENDENT SAFETY AND SOUNDNESS REGULATOR ALSO NEEDED TO ENSURE THE BANK SYSTEM REMAINS SAFE AND SOUND**

Most of the reports described the problems associated with the Finance Board's conflicting roles as governor/manager for the System, safety and soundness regulator, and programmatic regulator. The HUD, GAO, Finance Board, and Stockholder Study Committee reports each recommended that the management function be separated from the regulatory functions. The HUD and GAO reports recommended

merging the Finance Board's safety and soundness function into OFHEO while assigning programmatic oversight to the Secretary of HUD.<sup>4</sup> This would put Federal oversight of all three housing GSE's—the Bank System, Fannie Mae, and Freddie Mac—in the same places.

We agree that the Finance Board's current responsibilities are in conflict. We further believe that it is essential that the Bank System have a strong, independent safety and soundness regulator to implement the regulatory reforms of the Bank System that will be part of our comprehensive reform package. We recognize that OFHEO is a new agency and that its staff is working diligently to discharge their responsibilities with respect to Fannie Mae and Freddie Mac. Given HUD's recommendation, we are examining how the Bank System's safety and soundness regulation can best be accomplished and how the rest of the Finance Board's current responsibilities should be distributed.

### **III. Comprehensive Reform is Needed Because of the Interrelationships Among the Various Issues**

The five reports on the Federal Home Loan Bank System mandated by the Housing and Community Development Act point the direction for comprehensive reform and updating of the Bank System. These studies each covered 13 broad questions concerning the System. It is important to note that in the broad areas I have described this morning, there is general agreement across the five reports. This is good news, Mr. Chairman, for it suggests that a consensus on comprehensive reform is achievable.

To summarize, the reports generally agree that: (1) the Bank System serves an important function in making credit available to housing lenders; (2) membership rules need to be made consistent for all eligible members; (3) the Bank System should be able to continue meeting its FIRREA obligations, although the burden of those obligations is adding risk to the System and has certain perverse incentives; (4) Bank System capital needs to be restructured, with greater permanence given to System capital, and capital levels should be risk-based; and (5) the current responsibilities of the Finance Board, to be both manager and regulator, need to be separated. The Treasury Department concurs with each of these conclusions.

The reports also agree on one other point; that is, that achieving these changes and improvements to the Bank System requires comprehensive, not piecemeal, legislation. Each report describes the interconnectedness of the various issues. For example, moving all savings associations from mandatory to voluntary membership status must be done in conjunction with reforming the System's capital structure and rules. Otherwise, we risk a large exodus of mandatory members and possible disruption of the REFCorp payment.

Mr. Chairman, with the release of the final mandated study of the Bank System by HUD, the Treasury Department is working with HUD and others in the Administration to develop such a comprehensive reform package. As I have noted in my testimony, we do not yet have a completed proposal. We expect to complete our work by this fall and present a legislative proposal by early next year. Working with the Committee, we look forward to the passage of comprehensive Bank System reform legislation.

<sup>4</sup>The GAO report also suggested that OFHEO could be merged into the Finance Board, thereby making the combined regulator responsible for all housing-related GSE's but independent of HUD.

**STATEMENT BEFORE THE SENATE COMMITTEE  
ON BANKING, HOUSING AND URBAN AFFAIRS**

**FEDERAL HOME LOAN BANK SYSTEM**

**JUNE 15, 1994**



by

**NICOLAS P. RETSINAS  
ASSISTANT SECRETARY  
FOR HOUSING-FEDERAL HOUSING COMMISSIONER**

Thank you, Chairman Riegle and Members of the Committee, for inviting me to testify this morning on the Department of Housing and Urban Development's (HUD's) recently released study of the Federal Home Loan Bank System. I am here not only in my capacity as Assistant Secretary of HUD, but also as Secretary Cisneros' designated representative on the Federal Housing Finance Board (Housing Finance Board).

The Housing Finance Board is the safety and soundness regulator of the Federal Home Loan Bank System, and ensures that the System fulfills its public policy role as a primary source of funding for housing finance and also carries out its statutorily mandated Affordable Housing Program and Community Investment Program.

As you know, the Housing and Community Development Act of 1992 required the Department of Housing and Urban Development to study 14 specific questions regarding the Federal Home Loan Bank System and to submit a report containing any recommendations for legislative action to the Congressional Banking Committees. The Act also required reports on the same 14 topics from the General Accounting Office, the Housing Finance Board, the Congressional Budget Office, and a committee representing members of the 12 Federal Home Loan Banks. The HUD report reflects our effort to form a consensus through a cooperative, consultative process within the Administration. We believe it will pay dividends later as we work with the Treasury Department and others in the Administration to develop a comprehensive legislative proposal to modernize the Federal Home Loan Bank System.

While HUD's report provides answers to all 14 questions, today I would like to focus on the five most important topics raised by the study: (1) mission; (2) capital structure; (3) membership; (4) the effects of the financial obligations placed on the Federal Home Loan Bank System by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and (5) governance and regulation.

### **Mission**

The Federal Home Loan Bank System was created in 1932 in response to the Nation's need for a secure, dependable source of housing finance lending. To date, the System has remained safe and sound—never once suffering a credit loss in its 62-year history. That is a message worth noting. The Federal Home Loan Bank System is not broken, nor is it facing apocalypse, but we need to examine how it is positioned going forward, and the studies have provided this opportunity.

It is also important to note that the Federal Home Loan Bank System operates in a very different market environment today than it did 60 years ago or, for that matter, 5 years ago. The "wholesale" housing finance market has changed significantly in the past few decades as securitization has come to be the predominant financing mechanism, involving Ginnie Mae, Fannie Mae, Freddie Mac, and private conduits. The securitization process gives retail lenders a source of liquidity in exchange for their mortgages, enabling them to originate additional mortgages.

Despite the tremendous growth of the secondary market, the Federal Home Loan Bank System, through its over 4,600 member financial institutions, continues to serve an important support role for community-based lenders involved in the primary mortgage market. That is, Federal Home Loan Bank System advances (loans) make it more feasible for lenders to originate and hold loans that do not conform to secondary market underwriting standards but are nonetheless responsive to local needs and conditions. A Federal Home Loan Bank does this by accepting a member's pledge of home mortgages, other real estate-related collateral, or Government securities in return for an advance. It is this support of "portfolio lending" and the System's unique role in support of community-based lenders that sets the Federal Home Loan Bank System apart from the other wholesale sources of housing finance. At the outset of our study of the Federal Home Loan Bank System it was important to recognize this.

This led us to consider constructive change to enhance the underlying strength of the System and to ensure that it satisfies its mission. First, it is necessary to reaffirm and codify the public purpose of the Federal Home Loan Bank System—that the Federal Home Loan Banks should continue to specialize in collateralized advances to portfolio lenders. Further, we recommend that the System's mission statement include support for community development lending, multifamily lending, and lending for low- and moderate-income housing consistent with safe and sound operating practices. While the HUD report does not make any prescriptions or requirements for engaging in community development lending, we believe the strength of the System is in the potential of its community-based members. The Federal Home Loan Bank System, through its community-based members, is uniquely situated to affect and influence community lending.

With the essential purpose of the Federal Home Loan Bank System defined, we then sought to determine whether the System was making full use of its potential

in terms of its public purpose. We believe that while it is important that the Federal Home Loan Bank System assist community lenders, we should be able to demonstrate that the Federal Home Loan Bank System facilitates community lending.

The Federal Home Loan Banks' most visible initiatives in the area of community lending, to date, have been the Affordable Housing Program (AHP) and the Community Investment Program (CIP). The AHP is often cited as a national model of a successful housing program, having subsidized 63,000 units with \$237.4 million in subsidies leveraging \$3.3 billion in development costs. CIP advances are made to member institutions at the FHLBank's cost of funds plus administrative expenses. Since 1989, the CIP has experienced dramatic growth, having financed \$4.5 billion in community development loans including \$150 million for economic development projects. These are relatively new programs that are already achieving success and show promise for the future.

The HUD report recommends that the objectives of these programs be extended more generally to the overall advances program to further expand lending for housing for low- and moderate-income families, multifamily lending, and community development lending. An appropriate definition of community development lending, for this purpose, is loans that serve: (1) investment areas that meet objective distress criteria, or are located in designated empowerment zones or enterprise communities; or (2) targeted populations identified as being underserved by existing financial institutions whose purpose is to develop or support:

- Commercial facilities that enhance revitalization, community stability, or job creation and retention efforts in targeted areas.
- Business creation and expansion efforts that create or retain jobs for low-income people, enhance the availability of products and services to low-income people, or create or retain businesses owned by low-income people or residents of a targeted area.
- Community facilities that provide benefits to low-income people or enhance community stability.
- Home ownership opportunities that are affordable to low-income households.
- Rental housing that is principally affordable to low-income households.
- Activities of community development loan funds that support any of the above purposes.

To control operational costs to the Federal Home Loan Banks from nonresidential lending, eligible non-real estate community development loans should be supported by Federal Home Loan Banks in the same manner in which such loans may be supported in CIP; that is, they should count as authorized uses of advances, but traditional forms of collateral would be required to be pledged against these advances. It is not recommended that the categories of loans eligible to be pledged as collateral be altered. Consistent with this emphasis on controlling the risks that may accompany broadened programs, the 30-percent limit on use of other real estate-related collateral should be retained.

Our report also identifies several new initiatives for the Federal Home Loan Bank System to support multifamily lending within the scope of their existing lending authority. Already some innovative projects are using equity financing from AHP and debt financing from CIP.

For example, the Federal Home Loan Banks could serve as a clearinghouse to facilitate the sale of multifamily mortgages from one member to another. By facilitating the transfer of associated risks among members, the Federal Home Loan Banks could help increase the capital invested in multifamily housing development. In addition, the multifamily risk-sharing demonstration program authorized under section 542(b) of the Housing and Community Development Act of 1992 offers new possibilities for the Housing Finance Board, the Federal Home Loan Banks, and their member institutions to expand activities in the multifamily field. The demonstrations under this section are to involve partnerships, reinsurance, risk-sharing agreements, and other types of formal relationships between the Federal Housing Administration (FHA) and other organizations such as the Federal Home Loan Bank System, Fannie Mae, Freddie Mac, and other qualified financial institutions. In this case, risk would be shared between FHA and depository institution members of the Federal Home Loan Bank System, with coordination through the Federal Home Loan Banks and the Housing Finance Board. Like community lending, expanded support for multifamily lending should be accomplished while maintaining traditional forms of collateral to control risk.

### Capital Structure

As we look to the future of the Federal Home Loan Bank System, a core issue is the capital structure. Capital must provide the Federal Home Loan Banks with a financial cushion adequate to protect against the various risks in their operations.



The HUD report agrees with the other studies that strongly suggest the need for a permanent capital base. Further, we believe that appropriate levels of regulatory capital should be determined using both risk-based and minimum capital standards.

Despite these issues, it should be made clear that the Federal Home Loan Bank System is not currently undercapitalized. In fact, the most recent study of housing GSEs' risk ratings by Standard & Poor's gave the Federal Home Loan Bank System a AAA credit rating without any implicit Government backing.

Currently, the Federal Home Loan Banks raise capital by means of mandatory stock purchases by members, in accordance with statutory requirements. In addition, the Federal Home Loan Banks must comply with a 20-to-1 maximum debt-to-capital ratio and a maximum interest rate risk requirement established by the Housing Finance Board.

However, there are concerns that Federal Home Loan Bank System capital may be subject to what may be termed "membership risk," which is depletion of capital by members that can withdraw from the System and redeem their stock. This risk has been a factor since 1989, when the passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) provided membership for commercial banks and credit unions for the first time in the Federal Home Loan Bank System's history. These new members of the System can opt to voluntarily withdraw their membership and redeem their investment at par value. Prior to FIRREA, State-chartered savings banks and insurance companies were the only voluntary members. The growth in voluntary membership since FIRREA has steadily increased. At the end of 1989, voluntary members represented 8.8 percent of total System membership and accounted for 8.5 percent of total System capital. As of March 31, 1994, voluntary members represent 65 percent of total Federal Home Loan Bank System members and account for 36 percent of total Federal Home Loan Bank System capital. The upward trend in voluntary membership continues as the Federal Home Loan Bank System is now adding approximately 100 voluntary members a month—up from a monthly average of 75 in 1993. Membership risk will increase further in 1995 when State-chartered savings associations become voluntary members.

The HUD report discusses several alternative approaches for creating permanent capital to protect against financial risks. The report notes that the issuance of non-refundable, tradable stock could improve the System's protection against financial risks, including membership risk, at a lower capitalization than at present. To preserve the System's cooperative management structure, voting rights could accompany stock whose ownership is restricted to members. Issuance of certain financial instruments to private shareholders (i.e., other classes of common stock, preferred stock, or subordinated debt), or requiring that members that increase their use of advances purchase additional stock, could enable the Federal Home Loan Banks to increase and decrease capital cyclically with changes in advances. In any case, marketing of securities to the public would be viable only if the System is expected to be sufficiently profitable.

The report also notes that the Federal Home Loan Bank System could be required to build permanent capital through retained earnings. Since approximately \$2.5 billion of Federal Home Loan Bank retained earnings were taken to assist in funding the Resolution Funding Corporation (REFCorp), it would be important for the statute to provide assurances that Federal Home Loan Bank retained earnings are the property of the System's members and are protected from confiscation. Capital structures that combine elements of these two approaches may be possible.

The Federal Home Loan Bank System, recognizing the need for creating a permanent capital base, has formed a committee representing Federal Home Loan Bank System leaders to explore the various options to achieve this important objective. This committee includes representatives of the Federal Home Loan Banks, shareholders, and appointed public interest directors. We are pleased by this development and look forward to reviewing their report and recommendations along with receiving input from many other sources. It is critical to have the views of all affected parties, particularly those whose investment is at risk, in order to measure the viability of any proposal and to protect against regulatory uncertainty.

The Treasury Department is developing the Administration's proposal for restructuring System capital. HUD will work with the Treasury Department as options are developed. As indicated in our report, we expect that any capital restructuring proposal for the System will include risk-based capital and minimum capital requirements.

## **Membership**

The Federal Home Loan Bank System thrives on its ability to attract and retain capital. Evidence of this ability is the over 2,500 new voluntary members (commercial banks and credit unions) that have joined the System since 1989. We are con-

fidant in the fact that the System offers value to its members. In that spirit, and in the interest of fairness, the HUD report recommends that membership be voluntary for all Federal Home Loan Bank System members regardless of charter. It is important to note that HUD conditions its endorsement of voluntary membership on the establishment of permanent capital and risk-based capital standards for the System that ensures the System can handle the additional risks of voluntary membership while maintaining its capacity to meet its ongoing obligations. Specifically, HUD is committed to ensuring that the AHP and Resolution Funding Corporation (REFCorp) obligations are not undermined as the System moves toward fully voluntary membership.

Another membership issue involves the Qualified Thrift Lender (QTL) status of the System's members. To obtain advances, a savings association must meet the QTL requirement, which requires them to have mortgage-related assets equal to 65 percent of total assets. Also, Federal Home Loan Bank advances to non-QTL members—mostly commercial banks—are limited to 30 percent of aggregate System-wide advances. HUD believes the QTL test and the 30 percent limit should be eliminated as a condition of access to advances. The cap on System-wide advances to non-QTL members is an unnecessary potential deterrent to voluntary membership and may, in the future, constrain overall System support for housing finance and community development. It should be noted that the percentage of home mortgage loans held in portfolio by commercial bank members of the Federal Home Loan Bank System grew at an annual rate of 22 percent during 1992 and 1993, while non-member commercial banks increased their holdings of home mortgage loans at an annual rate of only 4 percent over the same period.

HUD's research indicates that a degree of concentration in mortgage-related assets (if properly managed) can be an effective profit-making strategy for a local portfolio lender. Thus, there remains an incentive for depository institutions to continue to specialize in mortgage lending, even if QTL rules governing advances are relaxed. In addition, the orientation of Federal Home Loan Bank members toward mortgage finance would be maintained through restrictions on collateral and use of advances.

Commercial banks and credit unions that do not qualify as QTL's face disincentives to borrow advances once they are Federal Home Loan Bank members since stock purchase requirements for non-QTL's are more costly than for QTL members.

We believe that equalizing the stock purchase requirements for all Federal Home Loan Bank members and removing the QTL test as a condition for access to advances will assist the Federal Home Loan Banks in fully realizing their potential in housing finance and community development lending.

Furthermore, HUD supports the current requirement that institutions must have at least 10 percent of their assets in residential mortgage loans to be eligible for Federal Home Loan Bank membership, but our recommendation goes further to recommend that, in keeping with the System's portfolio lending role, only whole loans (not mortgage-backed securities) be counted toward this requirement.

### **Effects of FIRREA on Federal Home Loan Bank System**

FIRREA placed several financial obligations on the Federal Home Loan Bank System. First, \$2.5 billion in Federal Home Loan Bank System retained earnings were used to defease the principle of the REFCorp bonds—a funding mechanism for the Resolution Trust Corporation.

Second, the Federal Home Loan Bank System was required to contribute \$300 million annually to help pay the interest on debt securities issued by REFCorp. Up to 20 percent of each Federal Home Loan Bank's annual earnings are allocated for REFCorp. If, after this initial 20 percent allocation, the total does not meet \$300 million, the shortfall is apportioned according to each Federal Home Loan Bank's share of the preceding year's advances to SAIF-insured members. It is important to note that, to date, the 20 percent allocation has not satisfied the total REFCorp obligation in any year, with the total obligation representing 34 percent of System earnings in 1993. In addition, there is a legislatively mandated contribution to the AHP which began at 5 percent of annual net income (with a minimum of \$50 million), and increases to 10 percent of annual net income (with a minimum of \$100 million) by 1995 and thereafter.

The REFCorp payments represent a statutory assessment on the Federal Home Loan Bank System and its member institutions which will continue until the year 2030. The AHP obligation will continue in perpetuity.

The annual REFCorp assessment of \$300 million was identified in 1989 as a fair share assessment on the Federal Home Loan Banks based on System earnings of \$1.5 billion in that year—significantly higher than current earnings. This burden, in our view, should be reduced. However, due to Federal budgetary procedures, this Federal Home Loan Bank System annual obligation cannot be reduced without find-

ing another available revenue source to make up the shortfall. The prospects for this seem unlikely, but we continue to explore and discuss any and all suggestions for resolving the REFCorp problem as we consider overall structural reform, including equalized membership access and restructured capital rules.

### **Governance and Regulation**

When FIRREA created the Housing Finance Board, the four following co-equal objectives were established for its operation:

- To supervise the Federal Home Loan Banks.
- To ensure that the Federal Home Loan Banks carry out their housing finance mission.
- To ensure that the Federal Home Loan Banks remain adequately capitalized and able to raise funds in the capital markets.
- To ensure that the Federal Home Loan Banks operate in a safe and sound manner.

The Housing and Community Development Act of 1992 prioritized these objectives by designating the safety and soundness role as the Housing Finance Board's "primary duty." However, a structural problem exists by virtue of the fact that the Housing Finance Board also performs a coordinating and leadership role for the Federal Home Loan Bank System. This arrangement is contrary to the principle that the roles of regulator and regulatee should be administratively separated. The Housing Finance Board also recognized this potential conflict of interest in its report to Congress on the Federal Home Loan Bank System.

With regard to the Housing Finance Board's regulatory role, HUD recommends that the Office of Federal Housing Enterprise Oversight (OFHEO) become the financial safety and soundness regulator for the Federal Home Loan Bank System. While this is HUD's current recommendation, we may be willing to revisit this issue as the legislative process proceeds.

In addition, program regulation should be administratively separated from program management and coordination activities to ensure appropriate objectivity. Program regulation functions include administration of community support requirements, monitoring, reviewing any new program for consistency with the stated purpose of the Federal Home Loan Bank System, the appointment of the non-elected directors of each Federal Home Loan Bank, and oversight of rules such as those governing collateralization and use of advances. Program regulation should be assigned to the Secretary of HUD, who has this responsibility with respect to Fannie Mae and Freddie Mac. The program regulator would have to seek the approval of the safety and soundness regulator for any actions that could have a major financial impact on the System or any individual Federal Home Loan Bank.

HUD also believes that the current program management and coordination responsibilities of the Housing Finance Board unnecessarily constrain Federal Home Loan Bank business decisions, thereby limiting potential Federal Home Loan Bank System growth and its ability to provide maximum support for housing and community development. The Housing Finance Board is taking interim steps to determine within the current statute which of these non-regulatory roles do not require central coordination and may be delegated to the Federal Home Loan Banks themselves. However, to fully realize the System's potential, we suggest that the Federal Home Loan Banks assume those non-regulatory roles currently performed by the Housing Finance Board, including the administration of the AHP and other strategic planning and central administration activities.

### **Conclusion**

HUD is convinced that the Federal Home Loan Bank System is fiscally sound and its role in support of residential mortgage financing continues to be critically important today. Nearly all market trends suggest favorable growth prospects for the Federal Home Loan Bank System. After several years, the trend of declining advances appears to be reversing itself with average advances above \$100 billion for the first quarter 1994, and up 25 percent over the first quarter of last year. As of March 31, 1994, total membership is 4,668—1,813 more members than at year-end 1990.

The AHP and CIP are well recognized as successful programs that encourage traditional financial institutions to increase their commitment to community lending. The Federal Home Loan Banks, through their Community Investment Officers and Affordable Housing Councils, are playing an ever increasing and important role in facilitating member institutions' compliance with the Community Reinvestment Act and its objectives by providing programmatic initiatives and technical assistance to their member institutions.

The HUD report seeks to build on the Federal Home Loan Bank System's strengths. We affirmatively state our continued belief that the support of portfolio

mortgage lending should remain the core function of the Federal Home Loan Banks. However, this report outlines specific reforms needed to improve Federal Home Loan Bank support of mortgage lending for low- and moderate-income housing and to expand Federal Home Loan Bank support of lending for community development. Just as importantly, the report details several measures that are necessary to continue to strengthen the safety and soundness of the Federal Home Loan Bank System and refine its membership and governance structure.

All of our recommendations are interrelated and interwoven. We do not believe any singular recommendation should be undertaken on a piecemeal basis, and that a comprehensive approach to Federal Home Loan Bank System modernization is required. HUD believes that with the completion of the five reports on the Federal Home Loan Bank System, this is the appropriate time to begin developing comprehensive legislation. It is my hope that today's hearing is yet another step toward that goal.

Again, thank you for calling this hearing today.

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## PREPARED STATEMENT OF MICHAEL T. CROWLEY, JR.

CHAIRMAN, FEDERAL HOME LOAN BANKS STOCKHOLDER STUDY COMMITTEE,  
MILWAUKEE, WI

JUNE 15, 1994

### Introduction

Mr. Chairman, Members of the Committee, on behalf of the Federal Home Loan Banks Stockholder Study Committee (Stockholder Committee), I would like to thank you for this opportunity to testify on our views on the FHLBank System. My name is Mike Crowley. I am the president and chief executive officer of Mutual Savings Bank, Milwaukee, WI, and Chairman of the Federal Home Loan Banks Stockholder Committee.

The Stockholder Committee was statutorily established by the Housing and Community Development Act of 1992<sup>1</sup> (HCDA). The members of the Stockholder Committee formally presented our report, "The Future Direction of the Federal Home Loan Bank System," in July 1993.

The original request from the Congress provided representatives of the Bank System's owners with a unique opportunity to meet for the first time to assess and debate the structure of the Bank System and to reach a consensus on the future evolution of the System. We gave the request particularly serious consideration, first, because of the importance of the System mission, and, second, because of the significance of our financial investments in the Bank System.

The Stockholder Committee consisted of 24 members—two stockholder representatives from each of the 12 Federal Home Loan Bank (FHLBank) Districts. (A list of the members of the Stockholder Committee is attached as Appendix A.) They were selected by the Board of Directors of each FHLBank. All are executive officers of their institutions and most are currently directors of their FHLBanks. As a formal matter, the main work of the Stockholder Committee was completed when we submitted our report last year, but we believe that the formation of the Stockholder Committee was instrumental in developing an across-district dialog that continues to this day and that has continued to shape System decisionmaking.

The Stockholder Committee's first meeting was on December 14, 1992, and we held seven additional meetings, the last on June 2, 1993. We also had extensive discussions with interested parties on the issues in the questions outlined in the HCDA. (A list of the parties is attached as Appendix B.) We greatly appreciate their cooperation and willingness to share their views with us and we know that Congress will also be seeking their views directly. We would emphasize, however, that the Study Committee does have a unique stake in the outcome of the policy debate on the role of the System since we represent the providers of the System's capital and the bearers of the System's risk.

The Stockholder Committee also collected, reviewed, and assessed information prepared by others regarding the Bank System, including studies prepared in 1990 and 1991 by the Department of the Treasury (Treasury), the Congressional Budget Office (CBO), and the General Accounting Office (GAO). We reviewed information prepared by the Federal Housing Finance Board (FHFB) in conjunction with its strategic plan for the Bank System (System 2000) and met on numerous occasions with FHFB members and staff. We held a briefing with directors of the Bank Sys-

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<sup>1</sup>Public Law No. 102-550, 106 Stat. 3672 (1992).

tem in Washington, DC, on March 9, 1993, to discuss the progress of the Stockholder Committee at that time. Further, I testified at the FHFB hearings on the future of the Bank System held in Washington, DC, on March 26, 1993. On May 26, 1993, we also met with the presidents of the FHLBanks to exchange views about the Bank System's challenges and opportunities.

Congress has now received the full complement of statutory reports about the Bank System. Although others will contribute to the assessment of the Bank System, no other group has our perspective, interest, and commitment. The stockholders of the FHLBanks are the owners, members, and users of the System: Their FHLBank membership is an integral part of their institutions' operations.

The Bank System was created by Congress in 1932. Since that date it has served as an important part of this Nation's housing finance mission. In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) made fundamental changes in the Bank System. The studies of the Bank System mandated by the HCDA are particularly relevant because significant changes in the Bank System's operating environment since FIRREA has made many of the key assumptions underlying the passage of FIRREA ripe for review.

For example, the imposition of the FHLBanks' obligation to provide \$300 million annually to the Resolution Funding Corporation (REFCorp) and the taking of \$2.5 billion of retained earnings from the FHLBanks on the initial formation of REFCorp were considered justified on the assumption that these were financial contributions of FHLBank members that had precipitated the thrift financial crisis. In fact, thrifts, which are still members of the Bank System, in 1993 were not the precipitators of financial crisis: To the contrary, they are most responsible for the thrift industry's restored financial stability.

Projections during the drafting of FIRREA, regarding future earnings of the FHLBanks, also proved to be overstated. In 1989, the \$300 million REFCorp obligation approximated 20 percent of the FHLBank's 1988 earnings. Congress, in creating this obligation, expected that earnings of the Bank System would continue at 1988 levels, or even grow. However, that has not been the case for various reasons. In fact, in 1993 the FHLBanks earned only \$972 million before the payment of the REFCorp obligation compared to \$1.5 billion in 1988. The capacity of the System to meet the FIRREA obligations has begun to recover as advances, which shrank to half of their 1988 level of \$150 billion, have recovered substantially, and, passing the \$100 billion mark, seem destined to grow for the foreseeable future.

The System is not "broke," but it does need some fix-up. Repairs do not have to be done on an emergency basis. This important power source helping to drive the portfolio lending process is actually working far better than it was 2 years ago. These encouraging trends afford us an opportunity to consider the strategic issues facing the System.

### **Housing Finance Mission**

The most basic topic to be decided for the System is updating and clarifying the mission statement. Definition of the public purpose for the System will highlight the areas where reform is most needed.

As stockholders and members of the FHLBanks, we believe the Bank System has made a significant contribution to housing finance throughout its history. More recently, the FHLBanks have been given additional responsibility for affordable housing, the major sector where housing credit flows remain constrained. We support the Bank System and depend on it in our day-to-day business. In our view, the mission of the Bank System is:

1. To promote the availability of housing finance to households of all income levels throughout the country in widely varying financial and economic cycles through the provision of advances and other services to member institutions.
2. To operate in an efficient, safe, and sound manner through the prudent management of risk to provide the Federal Home Loan Banks' members with access to competitively priced funds; liquidity; and high value financial, correspondent, and management services so that members, particularly those holding home mortgage portfolios, can more effectively compete and respond to the requirements of their markets.
3. To preserve stockholders' capital while simultaneously fulfilling the Federal Home Loan Banks' public trust and providing an acceptable rate of return to stockholders.
4. To provide members with the funds and programs necessary to expand affordable housing, thereby significantly enhancing the development of communities throughout the United States.

As with any brief mission statement, a set of assumptions and implications is embedded in the text. The first and last points of the language that the Stockholder

Committee offers for your consideration emphasizes the housing role of the System. The System's center of gravity must rest on the expertise of its professional staff and member institutions in this area.

The System functions on the "wholesale" level of financial services intermediation. It truly is a "bankers' bank." In most cases, the individual mortgage or business development borrower is completely unaware of the assistance that the System has provided. The access to the virtually unlimited liquidity of the System enables an institution to make far more loans within any given balance sheet total. This source of liquidity is actually more flexible than secondary market securitization since the loans do not have to meet this market's standardization criteria. Accordingly, the System offers this support to the overall portfolio lending efforts of its members but does place particular emphasis on the affordable housing segment for low-to-moderate income borrowers. The most effective assistance that the System can offer in neighborhood revitalization is housing credit, but we appreciate that the Community Investment Program (CIP) can be put to broader use and we can see real potential for that line of business when a local lender or Government body sees a good fit.

As these public policy goals are pursued consistent with that mission, the Stockholder Committee also feels that preservation of the financial integrity of the System is vital. The Stockholder Committee spent a great deal of time discussing ways to enhance the System's contribution to community development without raising safety-and-soundness concerns. As community-based lenders, we want to be involved in the measures that Congress is directing to enhance access to credit and economic development for neighborhoods that have taken a back seat on the national agenda for too long.

### **Community Development**

The Bank System and its members intend to continue to be major participants in community development banking and in any discussion relating to expansion of community development banking. We have developed the following recommendations for System activities to assist in that overall effort.

The Affordable Housing Program (AHP) could be more effectively administered if approval for program subsidies for individual projects is transferred from the FHFBS to the local FHLBanks. We appreciate the thrust of the proposed regulation to that effect still pending at the FHFBS, but many member institutions are concerned that the proposed regulation remains far too complex. This feeling is shared by many not-for-profit partners in the AHP. We are gratified that the HUD report confirms our views on this point.

The Stockholder Committee also suggests that, in the event of a merger of individual FHLBanks, branches or other types of local offices should be maintained to ensure that the effectiveness of the affordable housing and community development programs is not reduced. Again, the HUD report is consistent with our own views on this topic.

Our group also studied the relative affordable housing contribution of each of the housing sector GSE's. We note that the System is the only one of the three with an objective, dollar subsidy requirement, soon to reach \$100 million per year. Though Fannie Mae and Freddie Mac have specific targets for low-to-moderate and central-city lending, they expect to show a profit margin on these loans that is not significantly different from the rest of their book of business.

The financial commitment of the FHLBanks and their members to affordable housing substantially exceeds that burden. Thus, the goals established for these other GSE's are not relevant to the FHLBanks.

Our position on these issues was developed while Congress was in the very early stages of drafting the important Community Development Financial Institutions Bill, H.R.3474. We support the thrust of this legislation. Personally, I would like to thank Congress for the inclusion of a measure of regulatory relief within that pending legislation.

I believe that I can speak for all of the Stockholder Committee members when I emphasize that we are committed to performance over paperwork and to the enhancement of real community credit access. Portfolio lenders have voiced concerns that well-intentioned regulatory revisions under the Community Reinvestment Act will be very counterproductive. We hope that we can achieve real simplification and real upgrades in performance.

I do believe that, consistent with the basic mind-set of the stockholder report, the application of formal percentages of low-to-moderate mortgage loans (or other designated assets) against FHLBank advances outstanding can never be a workable approach to ensuring appropriate use of these funds. Many institutions are occasional borrowers from the System, but their commitment of funds to these uses is ongoing, stable, or increasing. The Community Support/CRA review regime is better suited

to assurance of mission fulfillment because of the difficulty of such asset/liability linkage caused by the fungibility of liability issuance proceeds.

### **Products and Services**

A more effective way to enhance the community development activities of the System is by seeking new business uses for its funding and credit enhancement capacity.

The expansion of the product menu for the System in support of community development or for other reasons must be carefully handled. Four basic criteria must be met before any new housing-related credit product or service should be offered by the FHLBanks to their members. New housing-related credit products and services must:

- Promote the Bank System's mission of housing finance;
- Be primarily an extension of credit for housing and housing-related finance for which the Bank System has the greatest amount of experience and expertise;
- Neither change the risk profile nor result in significant additional risk to the FHLBanks;
- Not duplicate housing-related credit products and services already offered by members.

After consideration of these four criteria, the Stockholder Committee concluded that the Bank System should not purchase unsecuritized housing-related assets or make direct loans for housing or housing construction. These recommendations were the same as those on this topic within the HUD report.

The Stockholder Committee did feel that the current limitation (30 percent of each member's capital) on the amount of residential real estate-related assets, other than fully disbursed first mortgages or MBS, that can be accepted by the FHLBanks as collateral for advances should be removed. It should be replaced by uniform limitations and guidelines to be monitored by the individual FHLBanks.

To maintain proper risk control procedures for reasons of safety-and-soundness, the stockholders, through their local Boards of Directors, should have final approval of any new product or service, and access to existing or new products and services should be available only to those currently eligible for access to FHLBank products and services. As a means of expanding their community development efforts, the FHLBanks should continue to offer credit enhancement services related to housing finance.

Furthermore, the FHLBanks should also be able to act as facilitators or clearing-houses for the syndication of loans that may be too large for individual members, but only at the request of members.

To address the financial exposure from these new activities, the Stockholder Committee suggests that pilot programs to test new concepts and minimize risk may be an appropriate way to enhance feasibility of product alternatives. The FHLBanks should have the ability to establish limited purpose subsidiaries for this purpose. The operation of any pilot program(s) should be limited to the geographic district of the sponsoring FHLBank(s).

### **Capital: Adequacy and Reform**

The above suggestion of using special purpose subsidiaries or pledged capital to manage the risk of new activities indicates the substantial attention that the Stockholder Committee paid to safety-and-soundness. The appropriate balancing of the countervailing forces to expand activities and to enhance capital was a major factor in the rewriting of the rules for Fannie Mae and Freddie Mac. Similar attention is necessary for the Bank System.

We would note, however, that capital investment in the Bank System is higher than needed for safety and soundness purposes under any traditional assessment of risk, including the ability to survive a risk-based capital stress test similar to the one required for Fannie Mae and Freddie Mac. The stockholders' contributions to capital should be reduced, subject to the ability of the Bank System to pay its REFCorp assessment and AHP obligation.

The minimum safety and soundness capital standards for the FHLBanks and the Bank System should be based on risk and overall financial condition, similar in purpose to the "stress tests" developed for these other two GSE's.

Ongoing capital adequacy standards for the Bank System should also reflect the ability to:

- Maintain the AAA credit rating;
- Cover the REFCorp assessment and Affordable Housing obligation; and
- Provide a reasonable dividend to stockholders.

The Bank System should have the necessary tools available to address capital adequacy, including the authority to permit the FHLBanks to issue different classes of stock to members, build permanent capital, and retain earnings without fear of confiscation.

The Stockholder Study Committee is pleased that these recommendations on capital, which were developed and delivered in our final report last July, began the consideration of the topic of provision of "permanent" capital for the System. This theme was expanded in the CBO and GAO reports that were completed after our work. The HUD report addresses the issue in somewhat greater detail, but does not give any specifics on the capital instruments that might be employed.

*A great deal of discussion took place within our Stockholder Committee last year, and I would emphasize that the involvement of the equity holders in any reconfiguration of the capital base is vital. At this point, virtually all of the capital in the System is represented by the holdings of redeemable common by the member institutions. Their reaction to any proposed overhaul will be critical to its feasibility and success.*

### **Governance**

Since members are the providers of the System's entirely private capital, they deserve a serious review of their role in governance. The studies that have addressed the issue in depth, those presented by the GAO and HUD, have recommended a separation between regulation and management. This issue was, however, first seriously raised by the Stockholder Study Committee.

This enhanced stockholder control should be accompanied by even greater Federal attention to safety and soundness via a single purpose regulator patterned after the Office of Federal Housing Enterprise Oversight, the overseer of Fannie Mae and Freddie Mac. The HUD report actually recommends a merger of the FHFB and OFHEO.

Our report was not so specific, but the committee discussed a range of alternatives for the location of this regulatory authority, including the Treasury, since fiscal soundness was the suggested focus for this operation.

The committee also recommended the creation of a central policy entity with a small staff and a Board of Directors to be responsible for Systemwide principles and policies, such as joint and several liability issues, capital, and risk management. Individual FHLBanks' Boards of Directors should elect one member to the Bank Systems' central policy entity. With that coordinating body in place, to the maximum extent feasible, local policymaking and governance decisions should be vested with the local FHLBanks' Boards of Directors. Management of the local FHLBanks should be, in turn, vested with local management responsible to their respective Boards of Directors.

The Stockholder Committee encourages consideration of consolidation among the FHLBanks. Concern for both shareholder control and a local presence requires that any consolidation among individual FHLBanks should be recommended by their respective Boards of Directors and approved by their stockholders. Legal impediments to consolidation should be reviewed and modified, or removed, as appropriate.

As part of that process, the Bank System's central policy entity should conduct a thorough study of the issues relating to consolidation of the FHLBanks, including, but not limited to, cost savings and the function, structure, and efficiency of the FHLBanks. These recommendations are again broadly consistent with the HUD study.

Since our committee was intimately familiar with the management of the individual FHLBanks, we did make two further recommendations on governance. First, the chairmen and vice chairmen should be elected by the local Boards of Directors. The presidents of the local FHLBanks should be selected and appointed by the local Boards of Directors.

Second, the terms of elected directors of the local Boards of Directors should be established at 4 rather than 2 years to be consistent with terms of the appointed directors. Directors should not be permitted to serve more than 2 consecutive terms.

### **Membership Recommendations**

Voluntary membership on a uniform basis must be extended to all members of the FHLBanks. A two-class membership, with different obligations and rights, is divisive, inefficient, and unsustainable. Access to membership in the FHLBanks should continue to be available only to thrifts, commercial banks, credit unions, and insurance companies, as under current rules, since these are the Nation's portfolio lenders.

Because of that orientation toward portfolio lenders, the current statutory minimum requirements for eligibility, including the requirement that insured depository



institutions have at least 10 percent of their total assets in residential mortgage loans, should continue to apply.

Consistent with uniform rules for membership, the stock purchase requirement for all members should be equalized when a single class of voluntary members is created. A two-pronged approach under that new uniform standard for members still continues to make sense, with some modest adjustment.

The stock purchase requirements should be determined by the Bank System's central policy entity, based on financial need and computed as follows:

- The initial stock purchase requirement should be based on a percentage of total assets rather than mortgage assets; and
- The stock purchase requirement for members to obtain advances should be based on a uniform percentage of advances.

FHLBank members that are currently required to meet the QTL test should be eligible to obtain advances without the QTL test qualification, and limitations on the amount of advances the Bank System may extend to non-QTL members should be eliminated.

Since members should be free to leave if they so desire, some constraint is necessary to prevent "revolving door" memberships. Thus, a member who voluntarily withdraws from the Bank System should not be permitted to rejoin for 5 years.

These recommendations are consistent with those contained in the other studies, but we emphasize that it is important to proceed with these changes in concert.

To quote directly from the text of our report: These issues "are significantly inter-related and cannot and should not be addressed in isolation. The Stockholder Committee is presenting interdependent recommendations that should be considered in their entirety. If they are not considered in their entirety, our positions on specific issues may be different."

The Stockholder Committee's recommendations were unanimous, in part because of the careful balancing of the individual items within the overall package. We are aware that Congress is unlikely to adopt every provision in our report, or in any of the others, without adjustment. Even so, we urge careful consideration of the connections between individual components of any package of System reform amendments.

Naturally, Congress is experienced in weighing competing arguments as legislation is crafted. That is the very nature of the legislative process. In that regard, we commend to your attention one final and difficult issue that hangs over from FIRREA.

That is the inflexible, first-dollar call on System earnings for the REFCorp contribution. We suggested a move to the flat 20 percent "tax rate" originally contemplated in FIRREA as a continuation of the old 20 percent transfer to the so-called legal reserve. We were, however, seriously concerned by the potential shortfall that such a switch might create.

We are intrigued by the approach outlined in the GAO report whereby any shortfall or surpluses from the 20 percent "tax yield" could be debited or credited to an interest bearing account to equate to the same "present value" burden but maintain the flexibility of the System. We did not offer that solution in our report, but I have discussed it with the members of our committee and we all agreed that it would be an equitable way to restore flexibility to the System's operation.

If nothing else, the range of analysis that has been presented to Congress from the individual perspectives of these five studies shows the wisdom of commissioning them in the first place and digesting their contents before moving legislation.

I would be happy to take any questions on the study that we submitted or on those presented by the other entities. Thank you for this opportunity to express our views.

## APPENDIX A

FEDERAL HOME LOAN BANK SYSTEM  
STOCKHOLDER COMMITTEE*Chairman*  
Chicago

Michael T. Crowley, Jr.  
President & CEO  
Mutual Savings Bank

*Vice Chairman*  
San Francisco

James F. Montgomery  
Chairman  
Great Western Bank

Atlanta

Richard E. Funke  
Chairman & President  
Atlantic Federal Savings Bank

Lynn W. Hodge  
President & CEO  
United Savings Bank, FSB

Boston

David F. Holland  
President & CEO  
Boston Federal Savings Bank

Herbert W. Cummings  
Vice Chairman  
Citizens Savings Bank

Cincinnati

Larry A. Caldwell  
President  
Cambridge Savings Bank

Tony D. Whitaker  
President  
First Federal Savings Bank

Chicago

John A. Becker  
Chairman & President  
Charter Bank, FSB

Dallas

Skip Martin  
President  
Pocahontas FS&LA

Manuel J. Mehos  
Chairman & CEO  
Coastal Banc Savings Assoc.

Des Moines

Donald A. Glas  
President  
First State FS&LA

Michael J. Gorman  
President  
United Postal Savings Assoc.

**Indianapolis**

\*Garry G. Carley  
Executive Vice President  
Standard Federal Bank

C. Gene Harling  
Chairman & CEO  
First Federal of Michigan

**New York**

Kenneth H. Van Saders  
President  
Clifton Savings Bank, SLA

\*George L. Engelke, Jr.  
President  
Astoria FS&LA

**Pittsburgh**

Norman L. Keller  
President & CEO  
Pennview Savings Bank

Edward J. Molnar  
President & CEO  
Harleysville Savings Bank

**Topeka**

\*Richard T. Ponorff  
President & CEO  
Mid-Continent FS&LA

\*Frank C. Sidles  
President & CEO  
Provident Federal Savings Bank

**San Francisco**

Herbert M. Sandler  
Chairman & CEO  
World Savings and Loan Association

**Seattle**

\*H. Brent Beesley  
Chairman & CEO  
Heritage Savings Bank

G.J. Pittenger  
President, Washington Division  
Great Western Bank

(\* ) Subcommittee Chairman

## APPENDIX B

## CONTACTS WITH INTERESTED ORGANIZATIONS

The Stockholder Committee has held extensive meetings with individuals representing both public and private sector organizations. We have considered all viewpoints and perspectives on the various issues confronting the Bank System. We have also met with other interested organizations on a continuing basis.

Wherever possible we have followed up preliminary contacts, met with them, and exchanged documents to understand, to the fullest extent, the impact of our recommendations on other organizations and interests involved in the Bank System.

The following individuals, agencies, and institutions have met with FHLBank stockholder representatives:

Agency/Institution	Contacts
American Bankers Association	Kenneth Clayton, Senior Federal Legislative Counsel and Gail Bolcar, Senior Policy Analyst
Congressional Budget Office	Douglas Hamilton, Principal Analyst, Fiscal Analysis Division
Congressman Richard Baker's Office	Duane Duncan, Legislative Director & Counsel and Paul Sawyer, Legislative Assistant
Department of Housing and Urban Development	Ben Laden, Director, Financial Institutions Regulation Staff; John Ross, Director, Economic and Public Finance Division; and John Gardner, Senior Economist
Department of the Treasury	Mark Kinsey and Margaret Nilson, Financial Economists
Federal Home Loan Bank Housing Advisory Councils	Chairpersons
Federal Home Loan Bank System	Presidents and Directors of the FHLBanks
Federal Home Loan Mortgage Corporation	Mitch Delk, Vice President, Government and Industry Relations; Ed Golding, Director, Policy and Planning, Financial Research Department; and Dick Pratt, Consultant
Federal Housing Finance Board	Board Members and Staff
Federal National Mortgage Association	Annette Enbourn, Vice President, Regulatory Activities, and Mark Obnoff, Senior Economist
General Accounting Office	Bill Kravant, Assistant Director, Financial Institutions and Markets; Ed DeMarco, Senior Economist; and Patrick Doerning, Operations Research Analyst
Independent Bankers Association of America	Diane Casey, Executive Director; Karen Thomas, Regulatory Counsel; and Ann Grochala, Director of Bank Operations

Mortgage Bankers Association	Phyllis Slesinger, Senior Director, and Victoria Vidal, Associate Director, Residential Finance/Government Agency Relations.
National Association of Home Builders	Kent Colton, Executive Director; David Ledford, Staff Vice President; David Sanders, Chief Economist; and Kathy Gerlach, Legislative Director
Neighborhood Reinvestment Corporation	George Knight, Executive Director
Office of Thrift Supervision	Jonathon Fiechter, Acting Director, and John Price, Acting Assistant Director for Policy
Savings and Community Bankers of America	Martin Regalia, Director, Economics and Research and Alfred Pollard, Director, Government Relations
Senate Banking Committee	Pat Lawler, Chief Economist

## PREPARED STATEMENT OF MARY LEE WIDENER

CHAIRMAN OF THE BOARD, FEDERAL HOME LOAN BANK OF SAN FRANCISCO,  
SAN FRANCISCO, CA

JUNE 15, 1994

### I. Introduction

Good morning. Chairman Riegle, Members of the Committee, thank you for inviting me to testify. My name is Mary Lee Widener. I am the chairman of the Board of Directors of the Federal Home Loan Bank of San Francisco. I also serve as president of Neighborhood Housing Services of America. My comments will reflect views developed from both these perspectives.

My relationship with the Federal Home Loan Bank System dates back to 1971 when I was employed by the Federal Home Loan Bank Board to help lead the thrift industry into productive and effective urban lending programs. That relationship deepened with my appointment in 1977 to be a director of the San Francisco Bank. I served in that capacity until 1982. In 1990, I became a member of the Affordable Housing Advisory Council to the San Francisco Bank and served as chairperson of the Affordable Housing Advisory Council from 1990 to 1993.

### II. Importance of Federal Home Loan Bank System

My service in the Federal Home Loan Bank System and through non-profit housing services to distressed neighborhoods has given me an opportunity to witness the dramatic changes in housing finance in the last two decades. As we address the issue of reforming the System, I am keenly aware that our challenge is to work for a consensus that will bring about changes that will ensure the long-term capacity of the entire System to support its housing mission through its service to the portfolio lenders. They are crucial to this country's most difficult housing and economic development needs, and play a preeminent role in fostering the work of community development organizations through the Affordable Housing Program and Community Investment Program.

The Federal Home Loan Bank System, acting through its members, is a vital link between the financial community and the low-income neighborhoods of this country. The Home Loan Banks and their members perform this function through several mechanisms: (1) general loans that support community-based portfolio lenders that make market rate loans in economically disadvantaged areas; (2) special loans that are targeted with below market rates for such areas; (3) direct subsidy grants through the Affordable Housing Program; and (4) human capital through their local leadership.

Some have questioned the continued need for the Home Loan Banks largely because of the success of Fannie Mae and Freddie Mac, in the secondary market, in helping millions of Americans obtain home loans. As we acknowledge this important success, we must also acknowledge that many families are not served by these GSE's. By their nature, Fannie and Freddie must have national uniform underwriting criteria. Homogeneous mortgage loans are what allow the secondary market to function so effectively. For the millions of mortgage applications, and millions of people whose home ownership dreams do not fit within this homogeneous loan criteria, another resource is needed. Just because a potential borrower does not fit within that mold does not mean that such a person does not represent a good credit risk; it just means that he or she is an individual, different in some manner from a statistical composite.

Part of America's strength is its diversity. Having a broad network of community-based lenders, with local standards, helps promote that diversity. The Home Loan Banks have successfully accomplished their primary mission for the past 60 years: Supporting lenders who make home loans. Providing our members with liquidity from the Federal Home Loan Banks gives them an incentive to hold otherwise illiquid consumer home mortgage loans that do not qualify for the secondary market and to be proactive in more difficult lending environments than otherwise would be feasible.

Access to Federal Home Loan Bank advances gives lenders the confidence that they will be able to hold loans that they cannot sell at full value and still meet either seasonal or cyclical demands from their depositors. In effect, access to Federal Home Loan Bank advances takes the liquidity risk out of lending to the families with the fewest financial options. The way to expand that access is by increasing the financial success of the System.

I want to state, in the strongest possible terms, that the members of the Federal Home Loan Bank of San Francisco have a positive effect on the lives of people in the communities in which they operate. South Central Los Angeles, for example, is

a community with well-known social and economic problems. Years of inadequate Federal and local support have been compounded by a State-wide recession, that was larger in scope than any recession since the Great Depression of the 1930's, and by an unprecedented string of natural disasters. The recession, which still lingers on in California, has caused a drastic cut-back in State services. This area needs new sources of private financing and Federal aid, but we also need to ensure that the existing public and private financial resources that are flowing into the region are not reduced.

The financial institutions that are members of the Federal Home Loan Bank of San Francisco are the most significant source of private financing that flows into South Central Los Angeles. According to the most recent Home Mortgage Disclosure Act data, Federal Home Loan Bank members make 39 percent of the mortgage loans in California; but in the low-income areas of South Central Los Angeles, Bank members make 65 percent of the mortgage loans. Home Loan Bank members made loans of \$895 million in South Central LA in 1992, of which \$726 million went to minority applicants. Our members' efforts in South Central Los Angeles are not an aberration. State-wide in California, Bank members do a disproportionately larger share of the lending in low-income neighborhoods. Bank members' ratio of mortgage loans originated in the low-income neighborhoods in California is 50 percent higher than the ratio of all other mortgage originators in California.

Mr. Chairman, let me emphasize, this lending is above and beyond the very successful Affordable Housing Program and Community Investment Program. These statistics represent the ongoing day-to-day business operations of private financial institutions in low-income communities. I believe we can, and must, do more. In designing new programs, we must be careful to nurture and preserve our base, and develop our capacity to grow stronger, not weaker, in addressing affordable housing needs.

I concur in the succinct statement of purpose for the Federal Home Loan Bank System, found on page 125 of the HUD study, which reads as follows:

The Federal Home Loan Bank System is a profit-making enterprise whose purpose is to support residential mortgage lending (including mortgages on housing for low- and moderate-income families), as well as community development lending, throughout the Nation, safely and soundly, primarily through a program of collateralized advances to System members. The System facilitates such lending by increasing the liquidity and improving the distribution of investment capital available through its member institutions.

I think this mission statement reflects the balance between the profit-making nature of the System and its social mission, which can only be accomplished through, and by the actions of, its members.

One issue that has resurfaced in the HUD study of the Federal Home Loan Bank System is the question of whether there is actually a cause and effect link between Federal Home Loan Bank advances and specific mortgage loans made by our shareholders. This question suggests to me an interest in tracing dollars that I believe would create cost and grief beyond comprehension with no benefit to anyone.

It is clear, beyond all doubt, that advances do play an important role in extending housing opportunities to more families by increasing the availability, and reducing the cost, of mortgage credit. It is not merely the funding of an advance that encourages our shareholders to extend credit to low- and moderate-income families not served by the secondary market. Rather, it is the knowledge that, as a member of the Bank System, the lender can take an otherwise illiquid loan to the Federal Home Loan Bank when it needs cash. In other words, a member's potential borrowing capacity at the Federal Home Loan Bank removes the liquidity risk from otherwise illiquid loans.

### III. The Need for Comprehensive Reform

The Administration has indicated that it will submit comprehensive legislation to Congress addressing Federal Home Loan Bank issues. I applaud and encourage such an effort. Comprehensive reform can increase the effectiveness of the System. In that regard, I believe that reform must be comprehensive, not piecemeal, in nature. We do not support the adoption of the cluster of amendments in the House version of the Community Development Financial Institution legislation affecting the Home Loan Banks in their current form. Such issues, however, should not be precluded from being adopted as part of a comprehensive package of reforms on capital, governance, and other issues. The System, including representatives of interested community development organizations, is working toward development of solutions to all of these issues and we look forward to a continuing dialog with the Administration and Congress.

We believe that to reform the Federal Home Loan Bank System in a proper manner, one must understand the balance that is critical to the success of the System. This balance has, on the one side, the Banks' business operations and, on the other, the central social missions they currently perform, and the challenge is to understand and maintain the link between the financial performance of the Banks and their ability to achieve the public purposes set forth by Congress.

The Federal Home Loan Bank System has functioned well in the past because it has maintained this balance between meeting the legitimate expectations of its shareholders for a reasonable return on their investment in the Banks, and fulfilling the public policy mission as set out by Congress. The System's shareholders have valued the System for the liquidity and lending functions it has performed, and for the dividend they receive on their capital investment in the System. It is investment of private capital in the Federal Home Loan Banks that enables the System to meet its public policy purpose without Federal tax dollars. That balance has been upset recently, and it could deteriorate further if changes are not made or if the wrong changes are made. The delicate balance between private interest and public purpose must be restored.

#### **IV. GAO is Correct: The REFCorp Allocation Formula is Unwise Public Policy**

Currently, the primary mission of the Federal Home Loan Banks is being distorted by their obligation to make interest payments on the bonds issued by the Resolution Funding Corporation (also known as REFCorp), and by the manner in which that obligation is allocated among the Federal Home Loan Banks. The Federal Home Loan Banks are required by law to make a fixed annual REFCorp payment of \$300 million. As the GAO has noted in its report on the Federal Home Loan Bank System, this fixed obligation has caused the Federal Home Loan Banks to greatly increase their investment portfolios, particularly their investments in mortgage-backed securities. The GAO found that this investment "has increased both the interest rate risk and management risk in the System, thereby raising the possibility that meeting the fixed obligations could conflict with the System's safety and soundness." The GAO is correct.

The Federal Home Loan Banks continue to hold large investment portfolios and soon will have mortgage-backed securities portfolios equal to three times their capital. Let there be no mistake about our position on this issue. We are not pleased to be in the business of investing in mortgage-backed securities, but the current drain on our funds is so significant that we find ourselves with no choice if we want the System to continue to function. As the CBO has noted, without these investments, the System could be in financial trouble. We believe that, after the System is reformed, the Federal Home Loan Banks should only hold short-term investments, and only enough of those investments to meet any temporary surge in demand for advances.

The other problem I wish to draw attention to, with respect to the REFCorp payments, is the formula for allocating the \$300 million among the 12 Banks. The REFCorp payment is allocated in two steps. First, each Bank pays 20 percent of its net income. Second, to the extent that aggregate amount does not equal \$300 million, each Bank pays an additional amount based on its share of total System advances outstanding to savings associations insured by the SAIF. This allocation method is unrelated to a Bank's ability to pay, which is the foundation for most Federal taxes. More importantly, the allocation actually discourages a Bank from making advances to its members in support of its primary housing mission. Ironically, the better job a Bank does at meeting its mission, the greater its portion of the assessment. The GAO and CBO make this point in their studies of the Federal Home Loan Bank System.

The GAO states that "The Shortfall Allocation Penalizes Lending and Could Disrupt the System," and the CBO reaches the conclusion, in its report on the System, that the REFCorp payment "subverts" a Federal Home Loan Bank's incentive to make advances to savings and loans. Both the GAO and CBO conclude that the formula penalizes the Federal Home Loan Banks for fulfilling the purpose for which they were chartered: Lending money to savings associations.

Let me illustrate the degree to which it does so. Whenever any Bank makes an advance to a SAIF-insured institution, its share of the REFCorp shortfall in future years increases. In the San Francisco Bank's case, increasing advances by \$1 billion will increase the Bank's share of the REFCorp assessment by nearly one full percentage point (90 basis points). Today, this means that more than \$1 million of the profit on these advances is paid in additional assessments.

In contrast, arbitrage investments, including those that have nothing to do with housing, have no effect on a Bank's share of the REFCorp shortfall. As a result, at



the San Francisco Bank, an investment with a spread of 11 basis points is as profitable on an after-REFCorp basis as an advance with a spread of 25 basis points. Both will produce net income of 8.6 basis points after REFCorp. Thus, the Bank is, in effect, encouraged to buy securities and it is discouraged from doing what it was chartered to do: Promote housing by lending to savings associations.

This discrepancy is even more apparent at a Federal Home Loan Bank, such as the Boston Bank, that pays a very small share of the shortfall. The Boston Bank is able to pass on more money to its shareholders from an arbitrage investment yielding 2 basis points than from an advance to a SAIF-insured member yielding 25 basis points. In sum, the shortfall allocation formula encourages all Federal Home Loan Banks to prefer lower-yielding investments to higher-yielding advances to SAIF-insured members, notwithstanding the fact that such investments may earn less money for the System as a whole. This hurts housing by increasing the shortfall, making less money available to finance home ownership/rental housing, and by making less money available for the Federal Home Loan Banks' Affordable Housing Programs.

#### V. HUD as Program Regulator

Before I begin my analysis of HUD's recommendations on what it calls "program options" for the Federal Home Loan Bank System, let me indicate my general discomfort with that term. I suggest that we need to think of these issues and frame them in terms of business opportunities and social responsibilities. Program options are something that a Government regulator administers through its regulatory power.

As you know, Congress established the Banks to perform a social mission as a provider of liquidity to promote housing finance. This social mission can only be accomplished, however, if members choose to remain in the System. We cannot force our members to take a loan from us. We do not operate by regulatory edict; we operate by offering our members access to loans that encourage lending for housing and home ownership.

I am concerned by HUD's recommendation that an "additional mechanism" be created to require the commercial banks and thrifts that borrow funds from a Federal Home Loan Bank to use a portion of those advances for housing for specified purposes. The HUD report suggests that specific collateral targets would have to be met, and a new reporting system established. This approach not only will fail to achieve HUD's objectives; it will be counterproductive. Such targets and requirements will discourage members from joining the System and from borrowing from the Banks.

The HUD study states that safety and soundness regulation should be separated from the Federal Housing Finance Board's current managerial responsibilities. All observers of the System agree on that point. We believe that the Boards of Directors of the Banks should be responsible for managing the Banks, and that the safety and soundness regulator should be responsible for examining and supervising the Banks in a manner consistent with other regulators.

Much discussion has occurred over the topic of who the regulator should be. The HUD proposal is that the Office of Federal Housing Enterprise Oversight be given responsibility for safety and soundness regulation, and that HUD be designated as the program regulator. It further leaves in place a potential governance role by the Federal Housing Finance Board. I am troubled by this possible three-party regulation of the Federal Home Loan Banks. The Affordable Housing Advisory Councils are unanimous in their opposition to the direction this suggests. We are opposed to the establishment of a program regulator that might encroach upon the ability of local community groups to participate, through the Community Reinvestment Act process, in the efforts of financial institutions to meet the credit needs of their local communities. Community development organizations place a high value on the private nature of the Federal Home Loan Banks. Clearly, there is a need for a safety and soundness regulator, but there is no such need for a separate and distinct program regulator. The core business of the Federal Home Loan Banks, lending to other financial institutions, should be administered by the individual Federal Home Loan Banks under the guidance of their Boards of Directors. The AHP- and CIP-targeted lending business has been, and can continue to be, effectively administered by the regional Home Loan Banks within national guidelines.

#### VI. Targeted Lending: AHP and CIP

In addition to supporting community-based lenders that originate and hold illiquid mortgage loans, the Federal Home Loan Banks also link the financial community and the low-income neighborhoods of this Nation through two targeted segments of our lending operations, the Affordable Housing Program and the Commu-

nity Investment Program. The contribution of the Federal Home Loan Banks to the Affordable Housing Program will increase another \$25 million this year to \$100 million per year. Community groups are universal in their acclaim that the Affordable Housing Program and the Community Investment Program are effective, targeted means of supporting the development of low-income communities.

The Affordable Housing Program provides Federal Home Loan Bank members with below-market-rate loans or direct subsidies to finance the construction or rehabilitation of projects to meet the needs of low-income communities. The Banks have provided about \$234 million in affordable housing subsidies since the program was initiated, assisting over 62,000 units of affordable housing, and another \$75 million has been set aside for subsidies to be awarded in 1994. The rate of contribution going forward is 10 percent of net income, with a minimum of \$100 million per year. Comprehensive reform of the System can enable it to earn more income and increase this contribution. Our Affordable Housing Advisory Council shares our strong desire to position the System to far exceed the current \$100 million flow of funds into AHP.

Advances under the CIP are made at a discount from the Banks' regular advances. These loans are priced to just cover direct costs; the Banks do not quite break even on the loans when indirect costs are added in. Our share of the REFCorp assessment, for example, increases each time we make a CIP loan to a savings and loan in our district. Thus, a Bank actually incurs losses on CIP loans because the REFCorp assessments are not calculated as a direct expense.

The purpose of the CIP is to encourage member institutions to make special efforts to increase their involvement in community revitalization and development. CIP advances may be used to support financing the construction, rehabilitation, or acquisition of residential or commercial property that benefits low- and moderate-income areas or families. Over \$5 billion in subsidized advances had been made under this program through March 31, 1994, funding over 137,000 housing units and \$170 million in economic development projects.

I would like to contrast our targeted lending business to the requirements for the other housing GSE's. FNMA and FHLMC have requirements to acquire loans made to families of moderate income, but Federal law states that they must earn a reasonable return on such investments. The Federal Home Loan Banks are housing GSE's required by law to subsidize loans; that is, the Banks must make these loans at a loss.

These targeted segments of our business have received support from the local communities that they serve because they are flexible, non-bureaucratic, and demonstrably improve the lives of people in the community. The staff at our Bank works hard to promote partnerships between non-profits and mainstream financial institutions.

The Community Investment Program has been used to support mostly housing activity. That is because most of our borrowers are specialized housing lenders. They do not do a lot of business lending, but our members that do engage in small business lending find the CIP to be very helpful. East-West Federal Bank received a \$4 million CIP advance in 1993 to support the permanent financing for a small shopping center in Los Angeles' Chinatown district. That particular community has a median income that is 44 percent of the area median income. The shopping center not only provides economic opportunity, it helps maintain the area as a focal point of the local community. To the extent we can encourage institutions that have the expertise in making these types of loans to join the System, we can expand these types of economic opportunities.

## **VII. Membership Requirements and Terms of Access for Advances**

The membership requirements of the Federal Home Loan Bank Act are a product of history, and a result of a compromise between the House and Senate in the FIRREA legislation passed in 1989. Prior to 1989, commercial banks and credit unions were not allowed to become members of a Federal Home Loan Bank. When FIRREA was adopted, Congress recognized the changing nature of the home mortgage lending industry, as commercial banks and credit unions began increasing their share of the home mortgage lending business. The Senate proposed letting commercial banks and credit unions join the System if they satisfied the same Qualified Thrift Lender, or QTL, test that applies to savings and loans; the House proposed letting all commercial banks and credit unions join. A compromise was reached whereby commercial banks and credit unions could join if they had at least 10 percent of their assets in mortgage loans, but lending was restricted so that no Federal Home Loan Bank could lend more than 30 percent of its advances to institutions that did not satisfy the QTL test. In the Housing and Community Development Act of 1992, that restriction on lending was further liberalized to permit an

individual Federal Home Loan Bank to exceed the limit of 30 percent of loans to institutions that did not pass the QTL test, so long as the System, as a whole, did not exceed the 30 percent limit.

One of the provisions of the House version of the CDFI Bill would raise the threshold for loans to non-QTL borrowers from 30 percent to 40 percent. The Federal Housing Finance Board reports that only 8 percent of System advances outstanding as of December 31, 1993, are to non-QTL borrowers. There obviously is no pressing need to increase that threshold now. While the provision's sponsor has displayed a true concern for comprehensive reform, not all of the provision's proponents are similarly motivated. There are some who will be opposed to comprehensive reform of the System.

The GAO has noted that the current structure of two classes of members, some voluntary and some mandatory, increases the risk to the System. The GAO has also stated that the System would be more stable and effective if membership were voluntary for all insured depository institutions. We agree. As part of comprehensive reform, for the long term, we think stock purchase requirements among all shareholders should be equalized. The two principles for constructing sound membership rules enunciated in the GAO study make a great deal of sense. First, the rules should equalize the benefits and burdens of membership for all members, irrespective of charter type. Second, the rules should give more control of the System to the shareholders of the Federal Home Loan Banks. This would allow them to operate their business in a manner that assures the System's responsiveness and, therefore, attractiveness to voluntary members.

#### **VIII. Taxpayer Exposure to the FHLB System: The Issue of Permanent Capital**

Some have suggested that the Federal Home Loan Banks pose an indirect risk of loss to the taxpayers because most members of the System are institutions with deposits insured by the FDIC. Any fair assessment of the actual risk of loss borne by the insured deposits of Bank members must take into account the actual risk profile of the Bank System. Given the current operations of the Bank System, the chance of a default of the magnitude necessary to affect the insured deposits of a member is so unlikely that the overwhelming amount of the expected risk of loss (which itself is minimal) is borne by the members' capital, not their insured deposits. During the past 60 years, no Federal Home Loan Bank has ever experienced a credit loss on a loan. Moreover, during the past 60 years, each Federal Home Loan Bank has reported positive earnings in every fiscal year. The stand-alone AAA ratings of 10 of the 12 Federal Home Loan Banks are a matter of public record.

The issue of Federal Home Loan Bank System capital, its appropriate amount and form, is a complex matter. I currently serve on a task force within the Federal Home Loan Bank System that is in the process of gathering and analyzing the latest financial data on this issue. It is important to note the interrelationship of the many issues confronting the Bank System. One of the primary objectives of the San Francisco Bank in participating in a design of the System's capital structure is to ensure the safety and soundness of the System. Also, capital issues cannot be divorced from the REFCorp burden, so fixing REFCorp should be addressed as part of the reform of the capital structure of the Bank System.

#### **IX. Summary of Views on HUD Study**

The HUD study makes three basic recommendations regarding the Federal Home Loan Bank System. First, it suggests establishing a new mandate for allocation of credit to Bank shareholders. Second, it endorses the creation of permanent capital and a statutory capital standard. Finally, it calls for equal access and stock purchase rules for all shareholders.

Let me briefly summarize our points of agreement with HUD. First, we agree that the overall focus of the System should remain on supporting community-based portfolio lenders. The Federal Home Loan Bank System needs to remain strong and financially sound.

Second, we agree that there is no need for the development of new products and lines of business that would increase risk in the System, and the System does not require expansion of membership outside the regulated financial institutions that are currently allowed to join. Securitizing loans is not a good idea; it would eventually lead to three housing GSE's in that business. Direct lending, as in construction lending, is an area in which those with experience suffer regular losses that would endanger the System's credit rating. There is no reason to think the System would do any better than its members, and as a start-up business, the System would undoubtedly do worse. Instead of new lines of business, we need to create more public/private partnerships that build on the existing strengths of the participants.

Third, we agree that the Federal Home Loan Banks need to have a statutory risk-based capital requirement, as other financial institutions do. The Federal Home Loan Bank System currently operates without a statutory capital standard requirement in terms of capital to assets. The only statutory standard related to capital is the minimum stock purchase requirements for Bank members.

Fourth, we agree that all potential members should have equal access to the System, and the same stock purchase rules. There should be no distinctions based on the type of charter held by an insured depository institution.

Finally, we agree that voluntary membership is necessary and inevitable.

There are, however, a number of points of disagreement with the HUD study.

First, we disagree with the concept of credit allocation formulas or the concept of placing limits on advances. The Federal Home Loan Banks are not designed to control the loans that their members make. Any effort to do so will discourage potential members from joining the System and encourage existing members to leave. We are wholesale lenders; our members do the retail lending. Retail lender activities need to be addressed directly so the disadvantages and advantages of the various approaches can be fully developed in open debate.

Second, we do not believe a program regulator is necessary. One regulator, focused on safety and soundness, will suffice.

Finally, we note that HUD did not address the REFCorp issue. We agree with GAO that the REFCorp contribution should be rationalized in order to minimize the risks in the System and remove the disincentive to make loans for housing and home ownership.

## X. Conclusion

Systematic and comprehensive reform is necessary in order to increase our effectiveness in helping portfolio lenders meet the credit needs of the communities they serve, especially low-income communities. We need to attract new members and to retain our existing members, which requires us to return the Federal Home Loan Banks to a higher level of profitability and pay a fair return on our members' investment in the Bank without the artificial boost from investing in mortgage-backed securities. The REFCorp assessment, the membership requirements, the capital structure, and the governance structure need to be reformed.

The REFCorp assessment appears to be the most difficult issue to address politically. There is a solution, if Congress and the Administration are willing to take a long view. The REFCorp assessment lasts for another 37 years, when the last REFCorp bonds are retired, but the pay-as-you-go rules measure the budget impact for only 5 years.

As the GAO noted, Congress could change the fixed \$300 million obligation to 20 percent of income and require the Federal Home Loan Banks to continue paying the Government past the maturity date of the REFCorp bonds to the extent the present value of such variable payments was less than the value under the current fixed \$300 million assessment. This reform would require a budget waiver because, although it is budget neutral over the 37 or more years that payments would be made on the REFCorp bonds, it is not budget neutral over the 5-year time frame used for scoring proposed legislation. It seems, however, that if ever a budget waiver would be warranted, it should be when GAO recommends it as a measure to reduce the long-term risk to the taxpayer in a manner that is, in the long run, budget neutral. REFCorp reform, along with changes to the System's membership and capital requirements and to its governance structure, will enhance the Banks' ability to successfully perform their housing finance mission.

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## PREPARED STATEMENT OF ALFRED A. DELLIBOVI

PRESIDENT, FEDERAL HOME LOAN BANK OF NEW YORK, NEW YORK, NY

JUNE 15, 1994

Good morning, Chairman Riegle. I'm Alfred DelliBovi, president of the Federal Home Loan Bank of New York. I am grateful for the opportunity to comment on the HUD study and possible legislation impacting the Federal Home Loan Bank System.

I believe the HUD study is a solid, thoughtful report. It, as well as the reports of the CBO, GAO, FHFB, and the Stockholders' Study Committee, should be thoroughly considered by Congress.

The New York Bank is in full agreement with the two central conclusions of the HUD study: One, that portfolio lending in support of mortgage financing is critically

important and, two, that support for mortgage portfolio lenders should remain the core function of the Home Loan Bank System.

For over three generations, the Home Loan Bank System has successfully served the public policy mission Congress has given it through the efforts of our private sector members who own the System. Providing our members with financial incentives has helped ensure the economic well-being of the communities and the people served by these local lenders. Through our 267 community-based shareholders, the New York Bank plays a key role in hundreds of communities in our district which includes New Jersey, New York, Puerto Rico, and the U.S. Virgin Islands. Similar economic contributions are being made by the other 11 Home Loan Banks, with local, member lenders, in thousands of communities across the Nation.

The System works well, and as the HUD study tells us, it is needed, and it is not broken. There are a few changes that potentially will make it work better, but we should be careful not to create problems in the process. Some will say that these changes should only be made as part of a comprehensive package, and we would likely support such a comprehensive legislative proposal. However, because the 2-year HUD study has just been completed, and because the key capital study is just getting underway, it is highly unlikely that a comprehensive proposal will, or should, be considered by Congress this session. While we look forward to working to develop comprehensive legislation in the future, we are in business today. Today, we and local member lenders should enjoy the benefits of a few legislative changes that common sense and reason dictate should be made.

To this end, the Board of Directors of the New York Home Loan Bank, last month, adopted a 1994 Home Loan Bank Legislative Agenda.

Specifically, the New York Bank's Board of Directors supports:

- Allowing the Home Loan Banks to incur daylight overdrafts under the Federal Reserve Bank's daylight overdraft rules.
- Allowing members that opted out of the System in 1989 and 1990 a 3-month "window of opportunity" to rejoin.
- Stating in statute that all management duties reside with the District Bank Boards.

The New York Bank hopes the nominations for the vacant FHFB seats are made in time for your consideration and Senate confirmation before the sine die recess of this Congress.

- If that is not possible, the New York Bank supports allowing the two existing members of the Federal Housing Finance Board to constitute a quorum until the existing vacancies are filled or a comprehensive change in the Finance Board structure is enacted by Congress.
- Supporting the Baker Amendment contained in the Community Development Banking and Financial Institutions Bill passed by the House, and a proposal that would calculate and apply a 40 percent non-QTL advance cap on an individual Bank basis.
- Amending section 2901 of the Community Reinvestment Act of 1977 which would encourage and recognize, for compliance purposes, lending by institutions who help meet the credit needs of the local communities in which they are chartered, or in such targeted low- and moderate-income neighborhoods designated by the appropriate State authority consistent with the CRA.

We believe these changes can be made during this session of Congress. These changes will help guarantee the continued significant contributions of our Affordable Housing Program, our Community Investment Program, and our payment of REFCorp assessments. They will ensure that we are better able to conduct business and meet our mission; a mission, highlighted by the HUD study, which is totally directed to supporting mortgage portfolio lenders.

During deliberations on these six specific points and other general issues of a comprehensive legislative package on the Home Loan System, it is critical to ask, if you will, the "fifteenth question" that the HCDA might have asked: "How do portfolio lenders, with the support of the Home Loan Bank System, do their business?"

First and foremost, local lenders conduct their business with complete knowledge of, and thorough commitment to, their communities. Portfolio lenders are in business for the long haul, and they are often located in the very heart of their communities. They are not merely temporary store front operations which only originate loans for housing units and close up shop if the market looks like it might turn.

The community lender is there to help finance a home for his or her neighbor. He or she is there to take deposits and offer savings accounts. They are there to cash checks, to make car or personal loans, and to keep valuables safe. In short, they serve to meet many of the diverse financial needs of their communities.

The ability to accept, as collateral, many types of mortgages, has enabled the Home Loan Banks to offer a unique foundation from which the local lender can play its key role in neighborhood building. With our flexible policies we can lend against a wide range of creditworthy, mortgage-related collateral. This flexibility has, in turn, enabled portfolio lenders to meet their customers' varying financial needs.

A great many of our local member lenders hold in portfolio a mortgage on a one-to-four family residence with a small business, such as a health care facility, a dry goods store, or a restaurant—the kinds of buildings located in every community—that is attached to the home. Other examples are a home with 21 boat slips in Suffolk County, NY, or a bed and breakfast in Upstate New York. These types of family properties typically do not fall within the guidelines of the secondary mortgage market.

Some of our portfolio lenders serve culturally diverse communities with different standards and practices for loan documentation. As a consequence, the mortgage documents do not conform to those of the secondary mortgage market, but do represent sound business.

Another significant area of support from the Home Loan Bank is for mixed-use multifamily properties. Let me just mention a few typical examples we have in our collateral vaults. In the Bronx, we accepted Oliver Gardens as collateral pledged for advances. This is a mixed-use building with 43 co-op apartments and, like so many other buildings in New York City, with small businesses on the ground floor.

In Ulster County, NY, we have as collateral a property with a non-conforming blanket mortgage covering a three-story building with eight apartments, one family cottage, and two garage buildings with nine bays.

Similarly, in Orange County, NY, we have as collateral a five-unit apartment building with documentation that would not comply with the cookie cutter requirements of the secondary mortgage market.

This flexibility in the types of collateral we accept allows the local lenders we serve in Puerto Rico to pledge 720 home loans originated under various housing programs sponsored by the Commonwealth.

Our community housing lenders don't make only unusual mortgages. The basic multifamily residential mortgage is a key part of the business strategy of many of the members in our district. Because of the special housing requirements of our metropolitan communities, our members have developed special expertise in multifamily lending. This is especially important in this sector of the residential mortgage market, because it is so clearly underserved by the secondary market. In fact, the multifamily mortgages that banks and thrifts hold in their portfolios total more than 3½ times all multifamily mortgage securities outstanding. The ability to pledge these mortgages at the Federal Home Loan Bank is a major factor in maintaining the flow of mortgage funding to this sector.

The traditional role of the banks in supporting home ownership through collateral lending was expanded by FIRREA through the Affordable Housing Program and the Community Investment Program. The subsidies offered by these programs are important tools to portfolio lenders in their efforts to help revitalize neighborhoods, maintain property values, and meet the credit needs of their communities.

Simply stated, the portfolio lender can count on the Home Loan Banks as a valuable and reliable source of funds to support mortgage lending operations. We serve as an important source of liquidity. A resource that enables a member to deploy a greater percentage of assets into mortgages or mortgage investments, thus increasing the availability of mortgage funds. Further, this access to ensured liquidity has been an important reason why over 2,500 community commercial banks have voluntarily joined the System.

Without question, the Home Loan Bank System serves an important role in our economy. This fact is underscored in each of the five studies mandated by Congress in 1992. There is another important fact that all of the studies agreed on: The System is well capitalized. This position of capital strength is reflected in the results of a special analysis to evaluate the stand-alone credit rating of the housing GSE's by Standard & Poor's. Standard & Poor's gave the Federal Home Loan Bank System a AAA credit rating on a stand-alone basis; that is, without any implicit Government backing. The Bank System is the only housing GSE to receive this high ranking. Furthermore, the System is among only a handful of banking institutions, worldwide, with a AAA stand-alone rating.

The System received this rating because of robust earnings, pristine asset quality, minimal interest rate risk, a vibrant customer base, and strong management. Nothing suggested in the five studies or in the System's own strategic framework will alter the System's fundamentally conservative operating philosophy.

As with all systems, the Home Loan Bank System is not absolutely risk free, but the risk in the System is not a risk of loss, rather, it is confined to the variability

in reported net income. This variability is largely associated with the cyclical movement of the economy and interest rates, due to the earnings capacity of our capital, and the changing prospects for funding increases in mortgage demand for our membership.

One of the strengths of the System is derived from the stock held by its member institutions. The U.S. Treasury does not own any stock in the System. Although Treasury provided the System's initial capitalization in 1932, the System retired all Treasury-owned stock by the early 1950's. For more than 40 years, the System has been capitalized entirely by private sector funds from private sector financial institutions.

It is for that reason that we strongly concur with Assistant Secretary Retsinas' statement last month to the House Banking Subcommittee that any proposal for restructuring the System's capital must involve the providers of the System's capital. As the Assistant Secretary said, restructuring capital cannot be "done behind closed doors."

The CBO, the GAO, and HUD have each put forth ideas on how the basic nature of the capital in the System could be improved. To respond to these ideas, the 12 District Banks are conducting a coordinated and comprehensive analysis of the System's capital structure and possible alternatives.

The objective of the study is to recommend viable alternatives for the capital structure of the System that address the concerns of the Government regarding the permanency of the capital while preserving the value of existing shareholders' investment.

The System's study is being conducted by a committee consisting of FHLB executives, thrift and commercial bank shareholders, and public interest directors of the Banks with the help of an investment banker, and outside legal and accounting counsel. Three representatives from the Finance Board—Directors Retsinas and Costiglio and Acting Managing Director Fair—serve ex officio on the committee.

Because the System is currently well capitalized and there is no danger—not even on the horizon—we should, in a measured and considered manner, thoroughly explore all options in this complicated question on the future structures of the System's capital. Some of the questions the capital study will address are:

- Should the System's capital structure be based on a holding company model, on the 12 separate Bank structures, or on a hybrid?
- Will there be multiple classes, such as common equity and preferred stock, and who will own the retained earnings?
- Can interests in the permanent capital component be transferred to other members or non-members?
- Is there a role for subordinated debt?
- What are the appropriate amounts of required capital subscriptions relative to mortgage assets, total assets, and advances?
- What changes can be accomplished within existing legislated authorities of the Federal Housing Finance Board?

This study's modeling and stress testing exercises will address the points contained in the Government's studies and Treasury comments today.

The capital study is just getting underway and should be completed by late summer or early fall. Any decision to restructure the System's capital prior to completion of the System's capital study would be unnecessarily premature, because it will have been made before the options have been weighed and their ramifications understood.

In conclusion, let me point out that the portfolio lender has relied on the Federal Home Loan Banks to serve as an integral partner for over 60 years. Through our programs, we ensure a flow of capital from Wall Street to Main Street. We are eager to work with Congress to help ensure that financing needs of all American home buyers are met.

Thank you.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR MURRAY  
FROM FRANK N. NEWMAN**

**Q.1.** Under current law, institutions that have withdrawn from the Federal Home Loan Bank System may not rejoin for 10 years. Perhaps at the time of its adoption, this provision may have seemed necessary in view of the uncertainties surrounding not only the FHLB System but also the entire banking system. Isn't it time to repeal this statute in order to encourage the highest possible volume of consumer-based lending by making the System accessible to the highest number of institutions?

**A.1.** We believe that, in a voluntary cooperative system, a moratorium on rejoining is essential to ensure membership stability, and thereby ensure financial stability. As described in our testimony and in the recently published reports on the FHLBank System, one weakness in the current System is that voluntary members are largely free to withdraw their capital on demand. The 10-year moratorium on rejoining the System after leaving it provides an incentive for members to examine the long-run value of the FHLBank System before deciding to leave.

As we described in our testimony, we believe that the problem with the lack of permanence with System capital can be handled by strengthening the rules governing capital redemptions when a member leaves the System. In an all-voluntary System, the moratorium on rejoining is integral to this approach to structuring System capital.

Without a moratorium, institutions would be free to enter and leave the System at will, making the financial management of a FHLBank subject to sudden increases and decreases in capital. This would also make the System less stable during periods of short-term economic turbulence or short-term financial problems within a FHLBank because members could withdraw their capital until the uncertainty was resolved. Thus, we conclude that a moratorium on rejoining is essential to the System's financial stability.

Finally, we do not believe that the moratorium should be waived for members that departed the System after FIRREA. By departing, these institutions avoided the risks and costs associated with System membership the past few years. It would be unfair to those institutions that remained in the System to now permit departed members to rejoin by waiving the 10-year moratorium in place at the time they elected to leave the System.

**Q.2.** The Administration has made a major effort to build public-private partnerships to help meet our Nation's housing and community development needs. I understand that some of the Federal Home Loan Banks would be interested in receiving enhanced discretionary authority to help meet those needs we see in our rural and urban areas.

As I understand the Administration's view in the HUD report, you argue that you would like the Banks to do more in the community development area, but you oppose allowing community development loans to be accepted as collateral. How can we expect our community banks to do more when we will not allow the Federal Home Loan Banks to be their partners?



What additional discretionary authority in the housing and community development areas would the Administration support for the Bank System?

**A.2.** The Administration has consistently encouraged depository institutions to strengthen their focus on community lending. Adding community development lending to the FHLBanks' mission is consistent with this policy. However, we also wish to retain the basic orientation of the System toward residential lending, and this is accomplished, in part, through the restrictions on eligible collateral.

For most members, the current collateral restrictions are a non-binding constraint on their advances borrowing. Also, *existing collateral rules, including the allowance of other real estate-related collateral up to 30 percent of a member's capital, already permit certain community development loans to serve as collateral.*

The FHLBanks are not equipped, at this time, to analyze the credit risk in most nonmortgage loans, including nonmortgage community development loans. Keeping collateral requirements as they are today is integral to maintaining the safety and soundness of the System. This is a practical solution as well because, if collateral rules were expanded to include all community development lending, the FHLBanks might have to increase the cost of those advances to factor in the uncertainty associated with that collateral.

Finally, FHLBanks are well equipped to serve as partners with their members in community development lending, not only through the Affordable Housing Program (AHP), the Community Investment Program (CIP), and the traditional advances program, but also through the technical assistance and outreach responsibilities of each FHLBank's Community Investment Officer.

#### RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM NICOLAS P. RETSINAS

**Q.1.** How has the absence of a quorum affected the workings of the Federal Housing Finance Board? Put another way, what percentage of the Finance Board decisions have been put off due to the lack of a quorum?

**A.1.** As of this time, none of the necessary decisionmaking and virtually none of the decisions of the Federal Housing Finance Board (Board) have been postponed due to the absence of a quorum. Under the operative principles of quorum law, the Board, acting without a quorum, may continue to carry out the day-to-day operations of the agency, functions prescribed by statute and regulation, and implementation of existing policy, which may include the exercise of professional judgment or discretion under the statute, regulation, or policy. This has allowed the Board to carry out agency business and to do all things necessary to the continued oversight, supervision, and governance of the FHLBank System.

For example, the Board has taken the following actions without a quorum:

- Approved AHP applications;
- Approved membership applications;
- Approved FHLBank dividend distributions;
- Conducted elections for elective directors of the FHLBank Boards;

- Designated vice chairs to fill vacancies in such positions on the FHLBank Boards;
- Approved FHLBank presidents' compensation and incentive awards under the existing Compensation Plan; and
- Approved an amendment to the Office of Finance 1994 Budget.

Further, the agency has been able to continue to conduct all necessary business due to actions that were taken by the Board acting with a quorum last fall, including the adoption of appropriate delegations of authority, which actions and delegations survive the loss of a quorum. For example, pursuant to the 1994 Strategic Plan of Examinations for the Federal Home Loan Banks (FHLBanks) that was adopted by the Board acting with a quorum last fall, examinations of all 12 of the FHLBanks and the Office of Finance are being conducted according to schedule. In 1994, seven examinations have been conducted, two are in process, and all 13 examinations will be completed by year-end.

Another important example was the adoption by the Board last fall, acting with a quorum, of a delegation of authority to the Secretary of HUD—"in the event that there is no Chairperson or Acting Chairperson" of the Board—of "all authorities, powers, and responsibilities of the Board necessary to effect the overall management, functioning, and organization of the [Federal Housing] Finance Board." This delegation, as well as another existing sub-delegation to the agency's Managing Director with respect to the day-to-day administration of the agency, also has facilitated the smooth functioning of the agency in the absence of a quorum.

However, absent a quorum, the Board will not be able to adopt or amend rules, regulations, or policies. Thus, for example, while agency staff continue to analyze the comments received in response to a proposed rulemaking on the Affordable Housing Program (AHP) adopted by the Board acting with a quorum, the adoption of a final rule will have to await a quorum. Similarly, other rulemakings that were initiated by the Board acting with a quorum, and rulemakings and changes to policy that currently are being developed by agency staff, will not be able to proceed when ready in the absence of a quorum. In each such case, however, considerable staff work is required before any of those rulemakings or changes to policy are ready for Board action.

Thus, while the Board, to date, has been able to conduct all necessary business—and should be able to continue to do so into the foreseeable future—the agency will be unable to adopt or revise existing rules or policies until it once again has a quorum.

**Q.2.** How has the absence of a quorum affected the workings of the General Counsel's Office? Put another way, what percentage of the General Counsel's work consists of deciding what actions the current quorum-less Finance Board can and cannot take?

**A.2.** The absence of a quorum has had minimal affect on the workings of the General Counsel's Office. While difficult to quantify, on average the amount of time that the General Counsel's Office has devoted to quorum and quorum-related matters would be in the range of 15 percent to 25 percent.

Certainly, considerably more time was devoted to quorum matters at the conclusion of 1993 and the inception of 1994 than is re-

quired on an ongoing basis, since at that time the agency was gearing up for, and first starting to operate under, the absence of a quorum. While on an ongoing basis specific actions contemplated by the Board necessitate legal analysis of the appropriateness of the actions absent a quorum, often such determinations dovetail with the legal review customarily and ordinarily undertaken with respect to any matters going to the Board for action.

**Q.3.** How has the absence of a quorum affected the personnel decisions of the Federal Housing Finance Board? Put another way, how many vacancies are there currently at the Federal Housing Finance Board?

**A.3.** The absence of a quorum has not really affected personnel decisions at the Finance Board, except as might be expected when it relates to the immediate Office of the Board of Directors.

We have delayed filling staff positions in the immediate Office of the Board of Directors since there are only two Board positions currently filled (one of which is the Secretary of HUD, an ex-officio position). We fill only the most critical positions to ensure that the mission of the agency is carried out.

Staff reductions have resulted due to careful management decisions reflecting recommendations from the Vice President's National Performance Review agenda, where appropriate. In addition, we are in the process of determining those authorities that may be most appropriately conducted by the FHLBanks without involvement of the Finance Board, thus reducing agency staff needs.

There are 22 vacancies currently at the Federal Housing Finance Board. The Board approved 109 full-time permanent and 19 other-than-full-time permanent positions for 1994. At the present time, the agency has 89 full-time permanent employees and 17 temporary employees, of which seven are summer interns. Aside from the vacant positions in the immediate Office of the Board of Directors, the reason we are 20 full-time positions below the approved level is because of the emphasis placed on streamlining agency operations.

**Q.4.** Given all of the above, what percentage of the Federal Housing Finance Board's maximum operating capacity has been diminished due to the absence of a quorum?

**A.4.** The Federal Housing Finance Board is continuing to operate at almost full capacity, even without a quorum. The agency continues to carry out the legislative requirements to supervise the Federal Home Loan Banks, ensure that the Banks are operated in a safe and sound manner, carry out their housing finance mission, and remain adequately capitalized and able to raise funds in the capital markets. The remaining Board Directors hold monthly Board Briefings, open to the public, and continue to visit the 12 FHLBanks, as necessary. Both of these activities were initiated by the present Board's predecessors.

**Q.5.A.** Recently the Board of Governors of the Federal Reserve System imposed new regulations concerning posting times for debits and credits to accounts maintained at Federal Reserve Banks. In addition, explicit charges for so-called daylight overdrafts (DOD's) have been established. Have these changes affected the capacity of

the FHLBanks to disburse the proceeds of its loans to community lenders?

**A.5.A.** The funding of FHLBank loans (called "advances") to community lenders is done through accounts established by the Federal Home Loan Bank ("FHLBank") for this purpose. In many instances, the member draws down the balance on its account when the funding is needed by requesting that the FHLBank transfer the proceeds via Fedwire.

However, the Fed's funds transfer regulations do not provide the FHLBanks access to the Fedwire on the same terms as other users. Generally, Fedwire users are permitted to overdraw their Fed accounts, intraday, up to a limited amount, called the net debit cap, which is based on an evaluation of the user's creditworthiness. While the Fed acknowledges that the FHLBanks pose no credit risk, it does not grant them access to a net debit cap. The Fed's position is that the FHLBanks should not incur any DOD's at all.

Maintaining sufficient excess balances at the Fed, to prevent DOD's entirely, is prohibitively expensive due to the loss of interest income on funds that would otherwise be invested. The Fed regulations clearly recognize this, and grant some latitude to all other frequent users of the Fedwire system.

We believe that the national payment system would not be jeopardized by allowing the FHLBanks net debit caps like other Fedwire users. No public policy benefit would accrue to the national payment system by denying equal access to the FHLBanks. In fact, the system may suffer from denying such access to the system's largest net seller of Fed funds.

Therefore, we strongly favor legislation to clarify that the Federal Home Loan Banks' use of the Fedwire should be under the same FRB Payment System Risk Policy guidelines applied to other Fedwire users.

In addition, recent Federal Reserve discussions have focused on extending the daylight overdraft restriction and fees to the book-entry debt issued by GSE's. This would act directly to increase the advance funding costs of the FHLBanks, and negatively impact housing affordability. We also would favor a specific statutory exemption from the daylight overdraft rules for book-entry GSE debt operations.

**Q.5.B.** Have these changes affected the capacity of the Home Loan Bank System to provide correspondent services to community lenders relative to Automated Clearing House (ACH) transactions? Would this be an example of the type of service you think the Home Loan Banks should or could be offering in support of their mission regarding community and economic development?

**A.5.B.** Prior to the implementation of the new regulations on October 14, 1993, daylight overdrafts related to ACH transactions were excused by the Federal Reserve System ("Fed"). The new regulations treat ACH overdrafts the same as all other DOD's. The Fed granted a 6-month grace period until April 14, 1994, before it would charge fees for DOD's. The Fed has since extended that grace period until October 14, 1994.

The Fed's initial fee structure for DOD's is fairly benign and does not pose a financial penalty that would prohibit the FHLBanks

from continuing to provide correspondent services to institutions engaged in community and economic development activities. However, absent access to net debit caps, the FHLBanks may re-evaluate their roles as providers of such services as DOD penalties increase.

**Q.5.C.** What other products or services do you recommend the Home Loan Banks should offer in support of community and economic development that are dependent on equal access to the national payment system?

**A.5.C.** It is anticipated that recommendations for other FHLBank products or services will be contained in a comprehensive legislative package for the FHLBank System to be considered during the next Congress. Equal access to the national payment system would allow the FHLBanks to provide these and other products and services more effectively and efficiently to community development lenders.

#### **RESPONSE TO WRITTEN QUESTIONS OF SENATOR MURRAY FROM NICOLAS P. RETSINAS**

**Q.1.** There is broad agreement that the Bank System's Affordable Housing Program has been so successful in large part because it is focused on a community level. As part of your effort to decentralize a number of bank functions, do you support giving the banks additional authority over the Affordable Housing Program?

**A.1.** I am strongly supportive of decentralizing many of the functions (specifically the governance functions) currently performed by the Board and vesting such functions, instead, in the Federal Home Loan Bank System (System). One of the areas that I believe particularly appropriate to be undertaken by the System, directly, is the approval of Affordable Housing Program (AHP) applications and modifications to approved AHP awards. In fact, the Board, last December, in adopting for public comment proposed amendments to its AHP regulation, specifically proposed decentralizing these functions.

#### **RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM ALFRED A. DELLIBOVI**

**Q.1.** How have these changes affected the New York Federal Home Loan Bank's eligibility for, and access to, the Fedwire?

**A.1.** The Federal Home Loan Bank of New York is eligible for Fedwire and continues to have access, but the evolution of the Board of Governors' Payment System Risk Policy has formally narrowed the Bank's access to daylight overdrafts, and raised the possibility of imposing "penalty" rates of interest on daylight overdrafts. In addition, the most recent development suggests that even the GSEs' congressionally mandated book-entry debt issuance and redemption may be restricted, fundamentally changed, or subjected to fees, including penalties, in the name of payment system risk reduction.

These changes place the Bank at a significant disadvantage in utilizing the Nation's payment system because, in contrast to the flexibility accorded to other financial institutions, the Bank has no leeway in originating or receiving payments through the system.

The Board of Governors' interpretation imposes a requirement that, during each minute of the business day, the Bank's payments may be made only when a positive balance exists in its account at the Fed. In contrast, other users of the payment system are permitted to incur such "daylight overdrafts" in amounts that range as high as  $2\frac{1}{4}$  times capital.

As a result of this disparate treatment, the Bank must rely on receipts from financial institutions that are allowed to incur daylight overdrafts before it may make payments for itself or its customers. If daylight overdrafts do occur, the FRB System has notified us that out-going wire activity would be restricted. Such action would effectively preclude us from servicing community lenders who depend on us to facilitate many of their core business activities.

**Q.2.** How has your mission—the mission of the Home Loan Banks—to provide support for home mortgage lending, and the more recent mission to provide funds for affordable housing, been affected by the Fed's action?

**A.2.** Any undue restriction of the Bank's ability to meet its customers' liquidity requirements, even though it may be of very short duration, clearly is contrary to the Bank's mission. Further, any increase in the Bank's cost of funds is reflected in higher interest rates for advances to member institutions degrading the Bank's support of housing and, especially, affordable housing where every funding advantage is important. Less obviously, the Bank supports the daily operations of its home-lending customers through the provision of correspondent services, such as securities safekeeping, electronic funds transfer, coin and currency and settlement services. These services generate substantial activity in our Federal Reserve account, much of it posted at times that cannot be simply forecasted. As a result, we regularly must delay sending out-going wires, the bulk of which represent funds available in support of housing finance and the liquefaction of portfolio mortgage assets.

**Q.3.** In your opinion, does use of the Fedwire system by the Federal Home Loan Banks cause undue exposure to the Federal Reserve System?

**A.3.** Not at all. The scope and nature of the Banks' use of Fedwire is modest compared with the flows of funds through the payment system. We think that the Banks' activities offer no particular risk to the Federal Reserve System.

The Federal Reserve has based its position that the Banks may not incur daylight overdrafts, in part, on the possibility that daylight overdrafts may become "overnight" or "real" overdrafts that pose a risk to the Federal Reserve. The Banks are recognized worldwide as a triple-A credit. Our obligations are accorded a 20 percent risk weighting by international risk-based capital standards. The Banks have never incurred a credit loss in their 62-year history, have ample capital, superior asset quality, and have a statutory borrowing facility of \$4 billion at the United States Treasury. In fact, the Federal Reserve Bank of New York, in its conduct of open-market operations, has been a frequent buyer of the Banks' long-term debt issues, so we think that the Banks themselves pose no credible risk to the Federal Reserve System.

**Q.4.** Has your use of the Fedwire caused any losses to the Fed in the past?

**A.4.** Our use of the Fedwire has never caused any losses to the Fed.

**Q.5.** How can Congress provide the Federal Home Loan Banks with continued use of the Fedwire without exposing the system to undue risks in order to support your important housing mission in the same manner and to the same extent as before the Fed's recent overdraft regulations?

**A.5.** The Federal Reserve believes it has no statutory authority to extend credit to the Federal Home Loan Banks at its discount window. According to the Federal Reserve Board's recent policy statement, daylight overdrafts ". . . will begin to appear more and more like overnight extensions of credit by Reserve Banks. . . ." Thus, the Federal Reserve believes that it has no choice but to deny the Federal Home Loan Banks the daylight overdraft facility that it routinely grants to other users of Fedwire, because of its perception that this may appear to be non-authorized lending.

Congress can amend the Federal Reserve Act or the Monetary Control Act of 1980 to clarify the status of intraday credit, and to clarify the status of the Federal Home Loan Banks with respect to permitting their use of the payment system within the existing framework of the Federal Reserve's Payment System Risk Policy. This would include the establishment of a net debit cap and the imposition of fees for any daylight overdrafts that do occur, calculated in the same manner as fees for other users. Congress can also specifically exempt the Banks' book-entry debt operations from the provisions of the Payment System Risk Policy. These two actions would alleviate the legal concerns of the Federal Reserve without exposing the payment system to undue risks. Moreover, we believe the potential for payment system gridlock would be substantially reduced by these legislative actions.

**Q.6.** Have you discussed this with the Federal Reserve?

**A.6.** The Banks' conversations with the Federal Reserve have always come back to the statutory interpretation identified in our previous answer.

**Q.7.** Has the Federal Housing Finance Board taken a position on this issue affecting the System?

**A.7.** We are not aware of any position that the Finance Board has taken on the issue itself. The Federal Housing Finance Board staff has assisted the Federal Reserve in working with the Banks to prevent daylight overdraft occurrence.



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