



Written Testimony of

America's Community Bankers

on

“Legislative Proposals on GSE Reform”

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Government Sponsored Enterprises Subcommittee

of the

Committee on Financial Services

of the

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Good Morning Chairman Kanjorski, Ranking Member Pryce, and members of the Subcommittee. My name is Arthur Connelly and I am the Chairman and CEO of South Shore Bancorp, MHC. South Shore Savings Bank is a wholly owned subsidiary of South Shore Bancorp, MHC. I serve on the board of the Federal Home Loan Bank of Boston, and South Shore Savings Bank is a seller/servicer for Fannie Mae and Freddie Mac. I am also the First Vice Chairman of America's Community Bankers ("ACB"), and I am testifying today on their behalf, and not in my capacity as a board member of the FHLBank of Boston. ACB's members originate 1 in 4 mortgages in the United States. South Shore is a \$915 million community bank in Weymouth, Massachusetts and our primary business is originating mortgages for families.

ACB was among the first to call for reform of the regulatory structure for Fannie Mae and Freddie Mac, and later was the first to call for consolidation of regulation of the Federal Home Loan Bank System regulation into a new regulator for Government Sponsored Enterprises (GSEs). ACB strongly supports legislation that meets the following essential criteria.

- **The new regulator must be independent.**
It is critical that a new world-class regulator for GSEs have the authority to conduct necessary supervision, regulation and budgeting for the GSEs independently from the Administration and the Congressional appropriations process.
- **The regulator must possess authority to clearly distinguish permissible secondary from impermissible primary market activities at Fannie Mae and Freddie Mac.**
- **Portfolio and capital authority must be adequate.**
The regulator must have regulatory and supervisory authorities' equivalent to that of the federal banking regulators, including authority to adjust portfolio holdings and capital requirements – for safety and soundness concerns.
- **The unique cooperative structure of the FHLBanks must be preserved.**
Regulation of the FHLBank System can be improved within the framework of a single consolidated GSE regulator, but only if adequate safeguards are provided to recognize and maintain the unique cooperative characteristics of the System.

ACB strongly supported the Federal Housing Finance Reform Act of 2005, which overwhelmingly passed the U.S. House of Representatives in the 109th Congress, and strongly supports passage of similar legislation in the 110th Congress.

Regulation of Fannie Mae and Freddie Mac

Throughout the debate on GSE regulatory reform, ACB has maintained that Fannie Mae and Freddie Mac need a new regulator with world-class regulatory powers modeled on those which Congress has established for the banking agencies. That is why we strongly supported H.R. 1461 in the 109th Congress and urged its passage. As the recent accounting and management scandals at Fannie Mae and Freddie Mac have demonstrated these institutions are too important to our national housing policy, financial markets and the economy as a whole to neglect with

inadequate supervision and regulation. Thankfully, these GSEs, if not out of the woods, are well on the way to better management and recovery. But, we have dodged the bullet, and may not be so lucky next time. Now is the time to preserve all that these important institutions can offer by providing for the regulatory structure that they warrant.

When we say a “world-class regulator,” we mean that a new GSE regulator must have certain authorities to ensure that Fannie Mae and Freddie Mac operate in a manner that is both safe and sound, consistent with their mission and within the purview of their charters. We believe that the powers of a “world-class regulator” include:

- The regulator must possess similar supervision and enforcement powers to those of federal banking agencies to maintain safety and soundness and guard against systemic risk,¹ and to insure compliance with all applicable laws.
- The regulator must have the resources and expertise to evaluate Fannie Mae’s and Freddie Mac’s performance, both as financially sound entities and as public purpose entities. The regulator should not be subject to the Congressional appropriations process.
- Capital requirements established for Fannie Mae and Freddie Mac should reflect the specific financial risks facing each, including realistic treatment of counter party risk. Freddie Mac’s and Fannie Mae’s capital requirements should be consistent with the capital requirements imposed on other federally regulated entities with similar risk profiles.
- The regulator should have authority to adjust all capital requirements for safety and soundness concerns.
- The regulator should establish appropriate housing goals for the enterprises.
- Congress should not directly govern portfolio holdings of Fannie Mae and Freddie Mac. However, in order to manage safety and soundness and systemic risk concerns, the regulator should have authority to adjust Fannie Mae and Freddie Mac’s portfolio holdings.

In addition to granting these authorities to the new regulator, ACB supports increased transparency and disclosure for Fannie Mae’s and Freddie Mac’s debt, equity and mortgage-backed securities. We believe that their disclosure should generally meet the standards applied by the SEC to public companies that issue securities. Fannie Mae and Freddie Mac issue publicly traded shares, and investors who purchase their stock have the right to the same level of disclosure from the GSEs as from any other publicly listed company.

However, ACB opposes any attempt to eliminate Fannie Mae and Freddie Mac’s exemption from having to register under the Securities Act of 1933. Both companies have agreed to meet the disclosures of the 1934 Securities and Exchange Act, which will provide SEC-regulated

¹ Several financial regulators define systemic risk. For instance, the joint interagency statement issued by the FRB, OCC and SEC on April 8, 2003 states: Systemic risk includes the risk that the failure of one participant in a transfer system or financial market to meet its required obligations will cause other participants to be unable to meet their obligations when due, causing significant liquidity or credit problems or threatening the stability of financial markets.

annual and quarterly disclosures for investors. Given the volume of debt issued by Fannie Mae and Freddie Mac, removing the exemption from the 1933 Act could prove unnecessarily costly and burdensome, and would not materially improve those disclosures essential to the investing public. ACB also opposes proposals to revoke or limit Fannie Mae and Freddie Mac's existing line of credit at the Department of the Treasury.

Secondary Market Role of Fannie Mae and Freddie Mac

ACB also believes that GSE reform legislation must reemphasize the secondary market nature of Fannie Mae and Freddie Mac's assigned role in the housing finance arena. ACB supports policies that explicitly prevent using the benefits of Fannie Mae and Freddie Mac's quasi-government agency status to engage in primary market activities, including eliminating or discouraging competition among private sector participants in the mortgage lending, servicing and ancillary markets. ACB believes that meaningful reform legislation should specifically outline that Fannie Mae and Freddie Mac must stay in the secondary market, and it must permit the new regulator to strictly prevent them from entering the primary market. In this regard, ACB urges the Committee to adopt language similar to that included in section 122 of H.R. 1461, which established that the Director "consider the definitions of the terms 'mortgage loan origination' and 'secondary mortgage market'."

Models for Affordable Housing Programs

ACB has not spoken out previously on the issue of affordable housing funds for secondary market housing GSEs, but we feel it is time to do so because of the unique and pioneering experience we have had with such funds. In 1989 AHP obligations were established for the FHLBanks. Since that time, ACB members continuously have held the majority of FHLBank System stock, and as a consequence have had the primary ownership interest in the operation of the programs. These AHP programs have been a model for success as a means of satisfying mission requirements reasonably expected in return for the GSE advantages conferred by Congress.

The success of the FHLBank AHP operations suggests certain characteristics that should be fostered in similar programs that are proposed for other GSEs. In particular, FHLBank AHPs most often engage the private sector in identification, funding or management of affordable housing projects using various partnerships. These partnerships uniquely combine private efficiency and management with attention to the greatest unmet community and social needs. ACB strongly recommends that any newly established AHPs draw heavily from the AHP experiences at the FHLBanks, especially the design to include private sector lenders and developers in all phases of the project development and management process.

Importance of the FHLBank System

As a community banker, I truly appreciate the critical role that GSEs play in providing community banks with the liquidity to keep us competitive with larger institutions. In my case, that is especially true of the FHLBank System.

South Shore Savings Bank is a member of the Federal Home Loan Bank of Boston and has average annual advances of between \$175-180 million. That's roughly 22 percent of our liabilities. We could not offer the mortgage products we do if we did not have access to FHLBank advances. We rely on the FHLBank System day in and day out to help us conduct our mortgage lending business in a safe and sound manner.

As an indication of the importance of the FHLBank System to the liquidity and funding of community banks, a recent study by ACB indicated that advances comprised 21 percent of the liabilities for member banks active in the System.² Further, in the recent Survey of Community Bank Executives conducted by Grant Thornton, 73 percent of the respondents reported that they used FHLBank advances as a source of funding in 2006 and 27 percent expected to increase their use in 2007, while 34% expected usage to be the same as last year.³ The survey also noted that finding adequate funding sources to support community lending was important for 77% of the respondents, but only 57% were confident that adequate funding would be available. These numbers confirm the importance of the FHLBank System to a broad base of community banks and are an indication of the evolution of the System in the past 17 years.

Community banks have a recognized history of superior performance in lending to low income and minority borrowers. Studies reported by the Federal Reserve have shown that "depository institutions have higher portfolio and market shares than the two for-profit government-sponsored enterprises that are active in the secondary market, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac")."⁴ The FHLBanks support this business with advances and a variety of programs, including the Affordable Housing Program ("AHP"). As noted, the FHLBank AHPs are excellent models of how GSEs can better support the urgent need to add to our nation's stock of affordable housing, especially where a directed subsidy is necessary to attain the goal. Community banks also have a strong record of lending to first time homebuyers. In 2004, according to a survey conducted by ACB, respondents reported that 12 percent of mortgage loans were made to first time home buyers.⁵ These activities would not have been possible without the access to advances and the local programs that are made possible because of the FHLBanks.

The System's structure has evolved over time and continues to provide a much needed source of funds for the majority of its member institutions. Advances make it possible for community banks to make sound home loans that may not conform to the strict criteria of the secondary market. FHLBank advances also provide an important alternative funding source for community

² *Washington e-Perspective*, America's Community Bankers, March 9, 2005

³ *Twelfth Annual Survey of Community Bank Executives*, Grant Thornton, March 2006

⁴ Volume 82, *Federal Reserve Bulletin* Number 12: page 1077

⁵ *2005 Real Estate Lending Survey*, America's Community Bankers, February 2005

banks that choose to keep loans they originate – whether conforming or not – in their own portfolios. Community banks rely on the advance window for funding particularly in this difficult environment where other funding sources often are not readily available.

As the debate progresses and Congress considers the concerns common to the FHLBank System and the secondary market GSEs, I urge you to ensure that the legislation provides a new regulatory structure that recognizes the unique and successful business model of the FHLBank System. Unlike Fannie Mae and Freddie Mac, which are publicly held companies, the System is a cooperative owned by its member institutions and each of the FHLBanks is jointly and severally liable to all the others. Both of these GSE business models have their strengths. Any revised regulatory system should continue to respect those differences, while advancing the common goal – to maintain their financial safety and soundness.

Regulation of the FHLBank System

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

Even with the creation and expansion of the secondary market for mortgage loans, many lenders today would not be able to serve their customers without funding from the FHLBanks. This is evident in the continual reliance on advances funding by member institutions. The loans these lenders make are frequently non-conforming or may be part of a targeted lending program. Community banks may also choose not to sell all of their loans to the secondary market because they prefer to maintain customer contact and service.

In 1989, as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the System membership was opened up to commercial banks and credit unions. Today the System includes 12 FHLBanks with over 8,000 members. The operations of the individual FHLBanks were separated from the supervisory functions that they had provided since 1932, and the current regulator, the Federal Housing Finance Board (“FHFB”), was created. In 1999, the System changed again with the imposition of new capital requirements and expanded collateral options.

While the FHFB has evolved as a regulator and placed a greater emphasis on the safe and sound operation of the FHLBanks and on supervision of the System, it still is subject to limited resources. The legislation must strengthen the regulator and provide a greater depth of resources and expertise.

The Rationale for Change

The rationale for including the FHLBanks and the FHFB in GSE Regulatory Reform is much

different than for the secondary market housing GSEs. First, financial problems and adjustments to uniform accounting standards under SEC guidance have been much less significant. Second, the FHFB operates under statutory guidance that provides strong regulatory authority and mission oversight consistent with what would be expected for a world class regulator, and substantially similar to statutory authorities provided to the banking agencies. Therefore, the first objective of any statutory change affecting FHLB System is to do no harm. This objective was reflected in H.R. 1461, and again in this year's discussion draft, by the fact that only a small portion of legislative proposals have addressed System issues. Improvements in regulation are expected primarily from synergies and expertise that should be available in a new regulatory structure. Substantive areas in which there may be synergies include interest rate risk management and accounting guidance.

Authority to Regulate the Capital Requirements of the FHLBanks

The FHFB's authority to regulate the capital requirements of the FHLBanks is both explicitly and implicitly provided for in the FHLB Act. The FHLB Act explicitly provides that, the FHFB must issue regulations prescribing uniform capital standards applicable to each FHLBank. These standards must require each FHLBank to meet the minimum leverage and risk-based capital requirements specified in the FHLB Act. The leverage requirement requires each FHLBank to maintain a minimum capital of five percent of assets.⁶ Further, each FHLBank must maintain permanent capital in an amount that is sufficient, as determined in accordance with FHFB regulations, to meet the credit risk and market risk, including interest rate risk, to which each FHLBank is subject based on a "stress" test established by the FHFB that "rigorously tests for changes in market variables, including changes in interest rates, rate volatility and changes in the shape of yield curve."⁷ Finally, the FHFB, in establishing the foregoing risk-based standards, is required to take "due consideration" of any risk-based capital test established by the OFHEO. The FHFB's implicit authority to regulate the capital requirements of the FHLBanks derives from its general duties and powers under the FHLB Act to insure safe and sound operation.

Authority to Establish the Type and Scope of Activities Permissible for the FHLBanks

The FHFB's authority to regulate the type and scope of permissible activities of the FHLBanks is expressly authorized under the FHLB Act with respect to specified activities of the FHLBanks, where such statutory authority is not expressly authorized, the FHFB has taken the position that the authority to authorize activities by FHLBanks is implied pursuant to its general duties and powers under Section 1422b of the FHLB Act.

⁶ 12 U.S.C. § 1426(a)(2)(A). In determining compliance with the minimum leverage ratio, the paid-in value of outstanding FHLBank Class B Stock and retained earnings, both based on a 1.5 multiplier, are deemed capital for purposes of meeting the 5 percent minimum leverage ratio, except that a FHLBank's total capital (determined without taking into account the 1.5 multiplier) may not be less than 4 percent of a FHLBank's total assets. 12 U.S.C. § 1426(a)(2)(B).

⁷ 12 U.S.C. § 1426(a)(3)(A) the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, with such modifications as the FHFB determines to be appropriate to reflect differences in operations between the FHLBanks and those enterprises. 12 U.S.C. § 4611. 12 U.S.C. § 1426(a)(3)(B).

The Future of the System

Because of the strength of the regulatory structure, there is minimal need to alter the statutory frame work for the FHLB System. The primary reasons for change are to provide a broader and deeper scale under which to carry out the statutory mandate and to improve the process for choosing member, independent and public interest directors on the boards of the FHLBanks. Also, any legislation should reflect the differences between the Federal Home Loan Bank System and Fannie Mae and Freddie Mac.

As the debate over the appropriate regulatory scheme for the GSEs develops, I cannot stress strongly enough the importance of preserving and maintaining the cooperative nature of the FHLBank System under a new structure of regulation and supervision of the System and the housing GSEs. The cooperative structure of the System is essential to preserving the benefits that member institutions provide to communities and families and fund through advances. One of the many strengths of the System is the ability of each of the 12 Banks to develop and tailor products that meet the changing and diverse needs of their own members.

The FHLBank System needs a strong, independent regulator that has the authority to supervise the individual Banks using the current statutory framework of powers. Any new regulator of the FHLBanks must have the authority to maintain the Banks' access to the capital markets and their current well-defined mission to support the mortgage finance, affordable housing, and community development activities of member banks.

The independence of the regulator is another important element. The regulator must be able to operate outside of the appropriations process and be funded in a manner that allocates the system's assessments predominantly to the regulation and supervision of the system. The ability to fund operations without having to resort to the annual Congressional appropriations process will insulate the regulator from concerns about unintended political influence, and ensure autonomy. In addition, the assessments that the regulator makes on the FHLBanks must be used to examine and supervise the FHLBanks.

In 1989, two assessments were placed on the earnings of the System. The first, AHP, is funded out of contributions from the net income of each FHLBank. The total contribution from all FHLBanks is required to be a minimum of \$100 million or 10 percent of earnings each year. This money is then allocated based on an application process developed by the FHFBS. The projects that receive funding include many housing and community development projects. This program is a good example of how special affordable housing and community partnerships can be funded by an assessment on the System. We strongly support the very successful AHP as it is structured and would not recommend any changes. As noted previously, we suggest that this model be used as Congress contemplates a similar initiative as it relates to Fannie Mae and Freddie Mac. Involving the primary market lenders is an excellent way to promote development.

The second assessment on the System is the obligation toward repayment of the interest on the RefCorp obligations. Each bank must pay an amount equal to 20 percent of net earnings to repay the obligations incurred in the 1980's. These assessments are a legacy obligation of the

System and are part of obligations which Congress imposed on the System, along with other mission requirements. This costly obligation will not expire until 2030.

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

The current corporate governance structure of the FHLBank System has been established by statute. Over the years certain governance functions have been devolved from the regulator to the FHLBanks themselves. The composition of the Boards of the each of the FHLBanks is a critical element in ensuring that the governance of the FHLBank is strong and balanced. As each of the FHLBanks has evolved into more sophisticated financial institutions, we believe that financial, business and operating expertise must be demonstrated by the Board of Directors of each FHLBank. Each FHLBank should have a Board that is composed of members with a stake in the System who understand the commitment and importance of serving on a FHLBank Board. As the financial structure of the Banks becomes increasingly complex, it is important to have strong financial qualifications for all directors so that they can effectively oversee the FHLBanks' operations.

Recently the FHFB passed a final interim rule to address the growing number of vacancies on the FHLBank boards in the Public Interest Director category. The rule called for the FHLBanks to provide the names of 2 candidates for each public interest director vacancy they have on their board. Although we commend the FHFB for seeking a solution to fill the boards, it is our preference that the boards be populated through an election, rather than appointment process. There is no regulator who knows the strengths and weaknesses of the boards better than the banks themselves. Even the current Chairman of the Federal Housing Finance Board agrees, and has state repeatedly that the regulator should not be in the position to appoint the regulated.

I wish to express my appreciation for this opportunity to testify on this important issue. The bright future of the FHLBanks and a strong well-regulated secondary market is a necessity to the day to day operations of many community banks, including South Shore and the communities we serve. I look forward to working with you and the members of the Subcommittee as the legislative process continues.