



INDEPENDENT COMMUNITY  
BANKERS *of* AMERICA

Testimony of

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On behalf of the

**Independent Community Bankers of America**

Before the

**Congress of the United States**  
**House of Representatives**  
**Committee on Financial Services Subcommittee on Capital Markets,**  
**Insurance, and Government Sponsored Enterprises**

Hearing on

**“Legislative Proposals on GSE Reform”**

March 12, 2007  
Washington, D.C.

Chairman Kanjorski, Ranking Member Pryce and members of the committee, my name is Mike Menzies, I am President and CEO of Easton Bank and Trust Company in Easton, Maryland, and I am pleased to testify today in my capacity as Vice Chairman of the Independent Community Bankers of America (ICBA). ICBA appreciates this opportunity to testify on proposals to improve the regulation of the housing government sponsored enterprises, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

## **ICBA Supports Improved GSE Regulation**

ICBA strongly supports efforts to improve the regulation of the housing GSEs. These institutions are vital to thousands of our nation's community banks. Like many community banks, Easton Bank has greatly benefited by a robust secondary market which enables us to sell mortgages and invest in mortgage-backed securities.

Though very different in key respects, all three of the GSEs provide community banks with irreplaceable access to the capital markets. This access allows our members to offer the same home mortgage products to our customers that the largest firms offer to theirs. In addition, the FHLBanks provide members advances for liquidity and asset/liability management. Thus, the GSEs need a strong, independent safety and soundness regulator to ensure they remain reliable sources of funding and liquidity for decades to come.

Chairman Frank, I would like to commend you for your leadership in the last Congress on this issue. ICBA was pleased to support the GSE reform legislation that cleared the House by a strong, bi-partisan vote. That bill contained many positive features including the creation of a world-class independent regulator, recognition of the unique structure and mission of the Federal Home Loan Bank System, and protection of the GSE status of the enterprises, which is so vital to ensuring the stability of the U.S. housing markets.

Because the GSEs are so important to community banks and their customers, ICBA urges Congress, in the strongest possible, terms to reject proposals that claim to improve GSE regulation but are actually designed to undermine their mission or pave the way for privatization. The mortgage marketplace already includes large private lenders that combine wholesale funding with aggressive national retail marketing. The housing GSEs make it possible to combine wholesale funding and community bank service at the local level. Rather than take any steps to undermine this unique mission, we recommend that Congress improve and enhance it by establishing a strong, independent regulator focused on safety and soundness.

There are a variety of ideas that could disrupt the functioning of the GSEs. One is to impose a cap on their growth or size. Another is to severely restrict the types of mortgage assets that could be included in their portfolios. ICBA strongly opposes the placement of arbitrary caps or limits without regard to the varying

needs of consumers over time. We believe that the GSEs should be able to operate within their mission without artificial limits. On the other hand, we understand that the regulator may need to impose growth limits for safety and soundness purposes. I will discuss this in more detail later in my testimony.

### **Structure of the Regulator**

ICBA has long supported world-class, independent regulatory agencies, such as the Federal Deposit Insurance Corporation and the Federal Reserve, which are governed by boards independent of the Department of Treasury. These agencies have worked effectively. Following that same model, ICBA believes that the GSEs' safety and soundness regulator must be independent of political influence. The Treasury Department—whose primary responsibility is the fiscal policy of our country—should not direct the nation's housing policy, just as it should not direct its monetary policy, because doing so would create a conflict with Treasury's primary purpose.

While ICBA has had misgivings about including the FHLBanks within the new regulatory structure, we recognize that there is a consensus to do so. If Congress creates a new agency to oversee all three housing GSEs, that agency must be structured and directed to maintain the cooperative ownership structure, operations, and mission of the FHLBanks. Though they share some characteristics with Fannie Mae and Freddie Mac – primarily their substantial borrowings in the capital markets – the cooperatively owned FHLBanks are very different from the publicly traded housing GSEs, Fannie Mae and Freddie Mac. In addition, the FHLBanks' primary mission is to provide advances to their members for liquidity and asset/liability management. FHLBank advances enable them to make and hold mortgages and other types of loans in their own portfolios—loans that generally are not securitizable. Unlike Fannie Mae and Freddie Mac, the FHLBanks do not securitize mortgages and sell them to the public.

We note that last year's House bill (H.R. 1461) would have given the deputy for mission oversight responsibility for both the housing mission and goals for Fannie Mae and Freddie Mac, and the housing mission for the FHLBanks. ICBA believes that these responsibilities should remain separate, recognizing the unique nature of the FHLBanks.

### **Powers of the Regulator**

Congress also should be cautious with respect to the powers that it confers on the new regulatory agency and its director. As a general rule, we believe that the powers of the new GSE regulator and its director should not surpass those at Federal banking agencies, particularly if the director will be operating independent of a board with executive authority. Given the enormous powers that have been discussed in the GSE debate, a director – unless fully

independent – could exercise significant political influence over the program and policy direction of the agency. The politically independent banking regulator model has worked well over the years, and Congress would be well served to follow it in this instance.

### **Secondary Versus Primary Market Activities**

Congress should not attempt to draw a “bright line” between primary and secondary market activities of Fannie and Freddie. Frankly, the workings of the modern mortgage market are not as tidy as some have suggested. For example, automated underwriting systems (AUSs) devised by Fannie Mae and Freddie Mac have been criticized as straying too close to the line between primary and secondary market activities. However, primary lenders like community banks have found great value in the AUSs. They enable community banks to quickly and objectively qualify a borrower for a mortgage and determine if that loan is saleable.

Standardization is one of the major contributions that the GSEs have made to mortgage lending. It has leveled the playing field between the largest and smallest lenders, providing consumers more choice and better service. Without this standardization, a community bank would be forced to choose a single secondary market outlet for the loans its originates, rather than being able to seek the best pricing for its customers. Thus, the GSEs are expediting and reducing cost in the primary loan process. They are not interfering with or controlling the borrower.

### **Limits on Portfolio Growth and Composition**

ICBA strongly opposes the placement of arbitrary, statutory caps on the size or composition of the housing GSEs portfolios. The GSEs must have the flexibility to expand and contract to meet the needs of the mortgage industry and ultimately consumers. Should statutory limits be placed on the GSEs, they may not be able to provide liquidity to lenders to meet heavy consumer demands for mortgages to buy new homes or refinance existing mortgages. Artificial limits on portfolio composition could have a similar effect.

We are also concerned that should statutory limits be placed on growth, Fannie and Freddie would be compelled by business reasons to give preference to their large volume customers. Under that scenario, community banks with relatively low origination volumes -- some as low as one or two mortgage loans a month -- would be shut out and not have a secondary market outlet. Under current rules, Fannie and Freddie can buy these loans for their own portfolios. Capping the GSEs' portfolios would seriously hamper the ability of our members to serve the mortgage needs of their customers.

I think it is also important to note that, from a macro perspective, placing limits on portfolio growth could make it difficult to raise the roughly \$1 trillion in mortgage funding needed each year to assure stability in the housing markets. To help raise these funds, the market needs to attract investors from all over the world. Given the current concerns about subprime and “Alt A” lending, the ability of Fannie Mae and Freddie Mac to increase the size of their portfolios is becoming more and more important. This flexibility will ensure that credit will continue flowing to credit worthy borrowers with less than perfect credit or to those who need a mortgage with certain nontraditional features.

We recognize that there are options being considered that would grant the new regulator certain powers to restrain portfolio growth or limit their composition. We strongly caution against granting the new regulator overly broad authorities to limit portfolio growth or composition except when it is needed to ensure the safety and soundness of the enterprise. The GSE regulator should have supervisory and examination tools, comparable to bank regulators, to control portfolios for safety and soundness reasons. These limits should not be used as tools to implement political ends. We are concerned that overly broad authority to limit growth or the composition of portfolios may become politicized, and subject to undue political interference. Therefore, any authority should be carefully crafted. As a general rule, we believe the new GSE regulator should have the same powers as bank regulators, not more.

## **Capital**

The new GSE regulator also will be able to regulate growth for safety and soundness reasons through adjustments to risk-based capital. A strong, independent regulator should have the authority, consistent with the current authority of banking regulators, to establish, and modify as necessary, risk-based capital the GSEs must hold to ensure their safety and soundness.

However, the regulator should not be permitted to use capital levels to change the nation’s housing policy. Congress should maintain control over the statutory or minimum capital standards for Fannie Mae and Freddie Mac, as currently is the case. Otherwise, a new regulator could be subject to political pressure to adjust program levels by raising minimum capital, reducing the amount of resources available for housing. This would give the regulator a degree of authority over housing levels in the United States that we feel is inappropriate.

In establishing the housing GSEs, Congress made the determination that housing is of sufficient importance in the economy and society that it should receive this special support. We have been concerned that support of housing could be significantly altered as the regulator changes with the administration. We do not see it in the best interest of our country’s well being to expose housing to this potential volatility.

## **Improvements to FHLBanks' Community Financial Institutions Program**

ICBA believes that Congress should set the specific missions for GSEs, including the FHLBanks, Fannie Mae, Freddie Mac and the Farm Credit System, and that the regulator should ensure that they are meeting their mission. The current statute refers to the fact that the FHLBanks have a "housing finance mission." This should remain. But in the Gramm-Leach-Bliley Act of 1999, Congress allowed FHLBank members that qualify as Community Financial Institutions to use long term advances for small businesses, small farms and small agri-businesses (and pledge loans to small business and agriculture as collateral), thereby expanding the mission of the FHLBanks beyond housing.

While some FHLBanks moved forward rapidly to help their members serve small businesses and agriculture, others have not. We do not think Congress envisioned these new authorities would be implemented in only certain FHLBank districts. The vast majority of Community Financial Institutions cannot pick and choose which FHLBank to take their business to, unlike the largest banking companies that have charters in more than one FHLBank district.

Therefore, ICBA urges Congress to clarify that, in addition to housing finance, the mission of the Federal Home Loan Banks includes providing liquidity and economic development funds to community financial institutions to serve their small farm, small agri-business and small business customers. Language providing this was included in the Senate Banking Committee version of GSE reform legislation in the last Congress. We hope you will include it in your legislation.

In addition, ICBA continues to strongly support a provision in the bill the House passed in the 109<sup>th</sup> Congress to increase the size of institutions eligible for the CFI program to \$1 billion in assets (with annual adjustments). Taken together, these provisions would enhance the program that Congress authorized in 1999.

## **FHLB Multidistrict Membership**

ICBA opposes permitting financial institutions to belong to more than one FHLBank using a single charter (multi-district membership). The current structure of the FHLBank system has worked well and there is no compelling reason to make changes in membership rules. The issues surrounding multi-district membership through a single charter are complex and many affect the FHLBanks' safety and soundness. Such membership could also undermine the existing regional structure.

## **Consolidation**

ICBA strongly supports the regional structure of the FHLBs. Consolidation of FHLBs should be driven by members, not the FHLB regulator, unless necessary for safety and soundness needs. We recognize that consolidation in the banking

industry has significantly affected the FHLBanks. Some FHLBanks have grown, while others have shrunk. This trend may well continue. As a representative of nearly 5,000 community financial institutions, nearly all members of FHLBanks, I'm here to tell you bigger is not necessarily better. Community banks put a high value on the regional structure of the FHLBanks that exists today because it reflects their regional diversity. Consolidation should only be considered by the regulator in the event that a FHLBank faces financial difficulties of such a magnitude that it can no longer maintain independent financial viability. Any consolidation not due to financial difficulties must be member driven and member approved since the members are the owners and users of the FHLBanks.

### **Concentration in the FHLBank System**

Concentration in borrowing through advances by the FHLBanks' largest members is of concern to ICBA. ICBA believes that this should be addressed by the system's regulator before a serious problem arises, such as default of a member that is a dominant advance borrower (and capital provider) or the loss of their business to another funding source. The regulator should establish concentration limits for advances for both individual FHLBanks and the FHLBank system to protect safety and soundness.

### **Affordable Housing Goals for the FHLBs**

We have heard suggestions that perhaps the FHLBanks should be subject to goals for the purchase of mortgages from low-and moderate-income individuals and certain other targeted populations and areas as are Fannie Mae and Freddie Mac. We have also heard the suggestion that these goals should be applied to advances. ICBA is opposed to this for several reasons. First, the FHLBanks currently pay 10 percent of their earnings into their Affordable Housing Program that goes directly to providing affordable housing. It is easy to track how the AHP funds are used. Second, we have witnessed extensive debates between Fannie Mae and Freddie Mac and HUD, the agency that sets their goals, over how the goals are determined, performance is measured and whether they are meeting their goals despite extensive regulations. In our view, it is unnecessary to impose this burdensome, costly process on the FHLBanks when their AHP programs and contributions are already meeting these obligations.

We also strongly object to imposing housing goals on the use of advances. The vast majority of FHLBank members are subject to the Community Reinvestment Act and regulatory oversight to ensure they are promoting affordable housing and serving low- and moderate-income customers. Again, this would be a significant additional and redundant regulatory burden on the FHLBank members and their customers.

## **Needed Adjustments**

While Congress need not, and should not, undertake fundamental changes to the structure and mission of the housing GSEs, several issues have arisen since Congress considered legislation in this area, particularly regarding the FHLBank System. We believe Congress can usefully address these concerns without getting bogged down in needless controversy.

**FHLBank Mission is Expanded by G-L-B Act.** As mentioned above, ICBA recommends that your bill include an amendment regarding mission that was included in last year's Senate Banking Committee bill. The amendment made clear that the mission of the FHLBanks includes providing support for small farms, small agribusiness, and small business financing, pursuant to the new Gramm-Leach-Bliley Act authorities.

**FHLBank Public Directors.** A number of changes have been made recently to the process of appointing public interest directors and electing member directors to the boards of the FHLBanks that warrant close monitoring in the coming election/appointment cycles.

The system of appointing public interest directors by the Finance Board (and the Finance Board's unwillingness to appoint them until recently) has been an area of concern. We support the Finance Board's recent decision to once again appoint public interest directors. Its recent interim final rule has made a substantial improvement over the previous system, within the constraints of the current statutory framework. ICBA believes that the rule fosters two key goals: reducing the role of politics in selecting public interest directors and enhancing the role of the individual FHLBanks in finding qualified directors with the expertise that the Bank needs.

While ICBA supports the rule, we believe that Congress could make additional beneficial changes. We support giving each FHLBank the authority to select a minority number of public interest directors, nominated by the board of directors and elected by members. In this manner, public interest directors can be selected to meet the particular needs of each FHLBank, and further reduce the role of politics. Selection of public interest directors by members rather than the regulator also enhances the independence of the regulator from the governance structure of an institution it regulates.

ICBA has urged the FHFB to closely monitor the implementation of recent regulatory changes to the process by which directors representing members are nominated and elected. It is imperative that FHLB boards--not FHLB staff or the FHFB or its staff--control communications to members in this process. Attached to this testimony is a comment letter that ICBA submitted to the Finance Board on this topic on February 23, 2007.

**Compensation.** In general, ICBA believes that it is proper for the boards of directors of the GSEs to set compensation policies. We also believe that Congress should consider removing limits on compensation for FHLBank directors. Their compensation was cut in 2000 and we think that Congress should reconsider levels so that FHLBanks are able to attract people of significant technical expertise to serve as directors. The regulator should promulgate regulations to guide boards in appropriately setting compensation policies. In setting compensation for the leaders of Fannie Mae, Freddie Mac and the FHLBanks, we recognize a balance must be maintained that reflects that these are GSEs conducting a public purpose, yet they are very complex financial institutions that need to attract highly skilled leaders.

### **Farm Credit System**

Since Congress is now debating significant regulatory reforms to the regulatory oversight of Fannie Mae, Freddie Mac and the FHLBanks, it is a good time to look at the oversight of another GSE, the Farm Credit System. Unlike the other GSEs under discussion, the Farm Credit System engages in direct retail banking activities, competing directly with community banks. We have seen the Farm Credit System engage in significant mission creep and it clearly needs a stronger regulator to ensure that it is adhering to its Congressionally mandated mission. The regulator of the Farm Credit System must be made more independent and transparent, with enhanced risk assessment capabilities. The Farm Credit System is engaged in many of the complex financial transactions that the other GSEs engage in and the regulator must have the ability to ensure they are conducted in a safe and sound manner. The FHLBanks, Fannie Mae and Freddie Mac now must register stock with the SEC, so too should the GSE Farm Credit System. ICBA has communicated these views to the House and Senate Agriculture Committees and strongly urged them to address these issues.

This issue is especially important in a year such as this when Congress is considering renewal of the farm bill. We expect the Farm Credit System to attempt to expand into non-farm lending through this legislation. ICBA commends the leadership of this committee for your letter to the leadership of the Agriculture Committee highlighting this potential expansion into lending under the Financial Services Committee's jurisdiction. We will continue to work with you on this issue.

### **Conclusion**

ICBA strongly supports efforts to improve the regulation of Fannie Mae, Freddie Mac and the FHLBs to ensure their long-term health and stability. Access to these GSEs is vital to the ability of community banks to provide financing options for housing, small businesses and agriculture. Many community banks rely on FHLBank advances for liquidity and asset/liability management. In this regard,

ICBA strongly opposes changing the GSE status of the enterprises that ensures capital market access.

As a general principle, the GSE regulator should have the powers held by banking regulators to supervise and examine insured depository institutions to ensure safe and sound institutions. The regulator must be independent of political influence. Its role should be to ensure the safety and soundness of the GSEs and to ensure they achieve their missions, but not to set policy for national homeownership levels.

Thank you for this opportunity to share with you the views of our nation's community bankers. I would be happy to answer any questions you or other committee members may have.



TERRY J. JORDE  
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*President and CEO*

Federal Housing Finance Board  
Attention: Public Comments  
1625 Eye Street NW  
Washington, DC 20006

RE: Interim Final Rule, Federal Home Loan Bank Appointive Directors

To Whom It May Concern:

The Independent Community Bankers of America<sup>1</sup> welcomes the opportunity to comment on the Federal Housing Finance Board's Interim Final Rule that establishes procedures for the selection of Federal Home Loan Bank appointive directors. Section 7(a) of the Federal Home Loan Bank Act authorizes the FHFB to appoint directors to the board of each FHLB, but existing rules do not provide procedures for doing so. Members also elect directors to FHLB boards to represent their interests. The FHFB believes that by adopting procedures for the selection of appointive directors, it will enhance its ability to identify and appoint well-qualified individuals to serve as FHLB directors.

### **Proposed Procedures**

On or before October 1<sup>st</sup> of each year, the board of each FHLB shall submit to the FHFB a list of eligible nominees who are well-qualified to fill the appointive directorships that will expire on December 31 of that year, along with a FHFB prescribed application form executed by each person on the list. If an appointive directorship becomes vacant prior to the expiration of its term, the board of directors of the FHLB shall submit a list of names in a like manner. The names of nominees on the list provided to the FHFB shall be 2 times the number of appointive directorships to be filled. The FHFB shall select from among the nominees on the list in appointing directors. If the FHFB does not fill all appointive directorships from the list initially submitted by the

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<sup>1</sup> *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

*With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than \$876 billion in assets \$692 billion in deposits, and more than \$589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).*

FHLB, it may require the FHLB to submit a supplemental list of nominees for its consideration.

Anyone who seeks to be appointed to the board of a FHLB may submit to it an executed appointive director application form that demonstrates that the individual both is eligible and has business, financial, housing, community and economic development, and/or leadership experience. Any other interested party may recommend to the FHLB that it consider a particular individual as a nominee for an appointive directorship, but the FHLB may not do so until the individual has provided the FHLB with an executed appointive director application form. The board of directors of the FHLB may consider any individual for inclusion on the list it submits to the FHFb provided it has determined that the individual is eligible and well-qualified for the appointive directorship.

### ICBA Comments

ICBA supports the procedures contained in the interim final rule (including the application form) and believes that they will make the selection process more transparent, enhance the quality of FHLB appointive directors and provide an opportunity for the selection of appointive directors that more closely match the needs of individual FHLBs.

ICBA also has several suggestions for the rule. First, we ask the FHFb to require the FHLBs to formally notify their members when they are seeking appointive director candidates. Some FHLBs are already doing this. FHLB members know and work closely with many individuals in their communities that would be highly qualified candidates. Members should be made aware of the selection process and how to submit candidate names.

Second, we ask that the FHFb clarify that if it does not fill all of the appointive directorships from the list initially submitted by a FHLB it **shall** rather than **may** require the FHLB to submit a supplemental list of nominees for its consideration. We believe that was the intent of the rule and the language change would clarify the process.

Third, we ask that the FHFb encourage the FHLBs to offer nominees who represent geographic diversity within the district. Nominees must be a bona fide resident of a state within the geographic area that the FHLB serves, but they could potentially come from a concentrated geographic area. Each FHLB serves members in a variety of states and in urban, suburban and rural areas. Elected directors represent geographic diversity and, to the extent possible, so should appointive directors.

We appreciate the opportunity to comment. If you would like to discuss our views further, please call me at (202) 659-8111 or email me at [ann.grochala@icba.org](mailto:ann.grochala@icba.org).

Sincerely,



Ann M. Grochala  
Director, Lending and Accounting Policy