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REMARKS BY FEDERAL HOUSING FINANCE BOARD CHAIRMAN JOHN T. KORSMO AT A CONFERENCE OF FEDERAL HOME LOAN BANK DIRECTORS

CORPORATE GOVERNANCE AND THE CULTURE OF RESPONSIBILITY

Washington, D.C.
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Thank you for joining us here for our conference, entitled the "Culture of Responsibility." Professor Elson gave us a good start on grasping just what that phrase entails, and I certainly appreciate his insights.

The fact he had to make a quick exit to fly to Atlanta for another speaking engagement tells us that corporate governance has attained a central place – a high profile – in the public debate. There's a big demand these days for the Charles Elsons of the world…and I, for one, am glad of it.

Corporate governance – while a recent coinage – is certainly no recent development. Machiavelli didn't know it at the time, back in the 16th Century, but he was making a good case for safety-and-soundness regulation when he wrote, "The fact is that a man who wants to act virtuously in every way necessarily comes to grief among so many who are not virtuous."

Of course, Machiavelli also said, and I'll paraphrase, he also said, "Any new person in charge should inflict all the pain he can right at the start, so people have a chance to get over it."

I can assure you, he was not talking about this conference. We plan to spread the pain out.

As a North Dakotan, I'm fonder of the words of Theodore Roosevelt, who spent several years ranching in the Badlands of my native state. Roosevelt once said that, were it not for his time in North Dakota, he would never have become President.

And when he had become a trust-busting President, in 1907, he framed the debate on corporate governance this way: "Men can never escape being governed. If from lawlessness or fickleness, from folly or self-indulgence, they refuse to govern themselves, then assuredly in the end they will have to be governed from the outside."

Today, we see the failure of people in the corporate world to govern themselves. The issue figured in many of last week's elections, and is a subject of daily reporting in the financial press and the national media. Last week, General Electric made headlines, and received positive reviews, with new rules about how its board will operate.

And the scandals – Enron, WorldCom, Tyco, ImClone, Martha Stewart, for gosh sake….all of them – have become a shorthand way to refer to the failures of governance – and the bigger, underlying questions of trust.

Those questions are: Can the public trust corporate executives and boards of directors?

Can the public trust government regulators to prevent wrongdoing, and to stop it when it does occur?

And we shouldn't forget a corollary: Can the public trust government policy makers and regulators to avoid causing even more harm as they attempt to do good? Certainly that's a question I ask myself every time the Finance Board casts a vote, and I suspect the law of unintended consequences will play a role in some of the reforms Professor Elson referred to earlier.

The consequences of losing the public's trust can be monumental. Uncertainty in the corporate world contributed to this year's troubles in the stock market. Tens of thousands of people lost jobs because of the failure to prevent fraud and wrongdoing; and many lost faith in the system.

This conference is about making certain that the public can place its complete trust in the Federal Home Loan Bank System and the 12 Banks that compose it….and that you fully deserve that trust. I know each and every one of you share that goal.

At this point, I want to talk about board governance, but other, relevant issues will also arise during this conference, including for example, transparency. To meet the needs of your member institutions and the public at large, it is critical that Banks be as open and understandable as possible – while acknowledging the demands of business. We'll be discussing disclosure tomorrow as one element of this transparency.

Now, as you may know, November is one of two sweeps month in television, when the networks roll out their blockbuster specials and superstars. Our conference is keeping with that theme – we have a great line-up of stars from the world of finance, government and corporate governance.

One of the cardinal rules of programming for November is to not show reruns. Even if you have to cobble together a show based on the "World's Wackiest Financial Regulations," you have to offer people something new.

I'm going to violate that rule today. Much of what I'm about to say will be familiar, certainly to those of you who attended our public interest director orientation last May.

But I am not afraid to repeat myself, or more accurately, to emphasize this core message – you are responsible for the corporate governance of the Federal Home Loan Bank of which you are a director.

The System, of course, differs in many, fundamental ways from the rest of the corporate world. The Banks do not sell stock to the public; they operate as a cooperative, comprised of member financial institutions. These realities were reflected in many of Professor Elson's comments earlier.

But in the real world, investors assume that the taxpayers will stand behind government- sponsored

enterprises, including the Federal Home Loan Bank System, if necessary. Of course, this assurance is not found in the congressional charters granted to Fannie Mae, Freddie Mac, or the Banks, but it is a very real market perception, as you well know.

That perception is worth many millions – no, actually many billions – to the members that own the Federal Home Loan Banks, and, just as importantly, to the homebuyers who are your ultimate customers.

And it is a perception that could be shaken if the Federal Home Loan Bank System does not maintain the highest level of corporate behavior, does not maintain a culture of responsibility.

Please do not misunderstand me: The Federal Home Loan Bank System has well earned the public's trust. I see no, to use Roosevelt's phrase, folly or self-indulgence.

And it is my goal, as chairman of the Federal Housing Finance Board, the agency responsible for safety-and-soundness and mission regulation of the System, that that trust be maintained and strengthened – a goal I'm sure my fellow Board members share.

For a variety of reasons, the Finance Board in recent years had lost its clear focus on the regulatory necessity of safety and soundness. We had skilled and talented people on staff, but we needed more of them, and they and we needed better direction.

For example: When I became chairman, the Finance Board's Office of Supervision had just eight examiners on staff - eight examiners to cover a dozen banks with assets in excess of seven hundred billion dollars.

We also had eight people in the agency's communications office, perhaps reflecting, I guess, a different set of priorities.

This was the state of play as the agency and the Federal Home Loan Banks entered the post-Gramm-Leach-Bliley era. With individual banks adopting new, modern capital structures, we at the Finance Board faced new regulatory challenges, including the likelihood of new business activities by the Banks.

The first step to address our shortcomings was to locate the best leadership available for our Office of Supervision, and in that I am happy to say we succeeded. We hired Dr. Stephen Cross - an experienced manager and regulator - from the FDIC, and he brought with him Mr. Christie Sciacca to serve as his deputy. You will hear from them tomorrow.

Steve and Christie reviewed the operations of the Supervision Office and discovered the obvious: We needed additional resources devoted to examination and other supervisory functions.

Yet I have never regarded the Federal Home Loan Banks - which pay the Finance Board's bills - as an endless source of largesse. So we undertook a reorganization to emphasize safety and soundness and to improve the agency's management structure without imposing new costs on the banks.

It meant eliminating 21 positions, which is never an easy step. But the reorganization has allowed us to begin the process of hiring 13 additional examiners, including three supervisory examiners, more than doubling our examination staff. We have already started on the process, and for the first time, we will place examiners around the country, to improve their understanding of the individual Banks they oversee.

We will also be hiring a supervisory mortgage specialist, better equipping us to deal with MPF and MPP products.

Again, I highlight these steps because the Finance Board must first and foremost ensure that the Federal Home Loan Banks are operating in a safe and sound manner, fulfilling their statutory duties and responsibilities and meeting the expectations of the public.

And as Board members – as elected members and public interest directors alike – your primary responsibility must be the same. When it comes to corporate governance, you are the first line of defense. If you refuse to govern yourselves, then assuredly, in the end, you will have to be governed from the outside. But that is certainly not how the system has been designed to operate, particularly post-Gramm-Leach-Bliley.

So let me turn to the regulations that govern the general authorities and duties of the Bank boards of directors. Because they define your job….your duties… as bank directors.

Section 917.2

> (a) Management of a Bank. The management of each Bank shall be vested in its board of directors. While Bank boards of directors may delegate the execution of operational functions to Bank personnel, the ultimate responsibility of each Bank's board of directors for that Bank's management is non-delegable.
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> (b) Duties of Bank directors. Each Bank director shall have the duty to:
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> > (1) Carry out his or her duties as director in good faith, in a manner such director believes to be in the best interests of the Bank, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances;
> > (2) Administer the affairs of the Bank fairly and impartially and without discrimination in favor of or against any member;
> > (3) At the time of the appointment or election, or within a reasonable time thereafter, have a working familiarity with basic finance and accounting practices, including the ability to read and understand the Bank's balance sheet and income statement and to ask substantive questions of management and the internal and external auditors; and
> > (4) Direct the operation of the Bank in conformity with the requirements set forth in the Act and this chapter.

Note the language: "The ultimate responsibility of each Bank's board of directors for that Bank's management is non-delegable." In other words, you bear ultimate responsibility for the operation of the Bank. You cannot hand it off.

When I first became chairman a year ago December, I began asking Bank presidents and others how to make certain the Boards were up to these critical responsibilities. I was particularly interested in their insights because the Finance Board was in the process of selecting 36 new public interest directors.

Frankly, I heard some concerns. I can tell you, for example, that I attended a reception with board members from one of the banks very shortly before this process, and was told, "We need the very best people you can find." One of the members of the board told me, "One of our appointed directors doesn't

know what a demand account is."

We have to keep in mind that these are very large financial institutions. The average bank has assets of $58 billion. All twelve of the banks are in the top 53 banking institutions in the country in terms of size of assets. Our largest bank, the Federal Home Loan Bank of San Francisco, has assets in excess of $130 billion. The system in aggregate is a $700 billion system with capital approaching $35 billion.

These are big financial institutions, and it's difficult for them to operate, particularly given the statutory mandate that the board members have, when the level of knowledge of the members of the board falls short – again, that's true of both elected and appointed directors.

Another one of the bank presidents sent me a letter suggesting to me the factors that should be considered in selecting appointive directors. Let me tell you what they are, because they are the base my colleagues and I will be working from in making appointments. Here's the list of characteristics this president said the board members should possess:

> **An understanding of finance.** Again, these are large institutions – board members should be able to read a balance sheet, and make informed judgments about the operations of their Federal Home Loan Bank.
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> **Political awareness.** Obviously, these banks are creatures of politics, and so they'd like to have people who have some understanding of the political process. I'll speak more about this later, but it is my view that you – as directors – are in the best position to argue your Bank's case – and indeed the System's case – to members of Congress.
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> **Experience in a corporate governance environment.** Director Leichter and I had this conversation, literally, the first time we met, on the important role of these boards in governing these banks. When one of your member institutions asks about corporate governance, all of you should be able to speak with confidence about how your board represents their interests.
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> The fourth necessary attribute the president mentioned to me in his letter was **diversity –** and while that includes gender and racial diversity, it's also relevant to geography and life experience. Obviously, it's important that Banks benefit from the perspectives of people with different points of view serving in these boards.
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> Fifth, a **demonstrated interest in the mission of the bank**. The primary mission of these banks, of course, is to provide liquidity to its member financial institutions. But I think it's also important that board members have a demonstrated interest in and commitment to the housing finance mission of the banks.
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> Sixth, then, he said, is an **ability to work with others directors as a board.** The Banks obviously benefit from strong leaders on the board, but leaders who understand they are working with others on issues of mutual interest…and for the public interest. One of the characteristics that I looked for when I was going through the biographies of potential public interest directors was that these people had worked in a board environment before, and worked effectively.

These are not arbitrary characteristics, and the list is probably not exhaustive. But board members who possess these characteristics are essential to maintaining good corporate governance of the 12 Federal

Home Loan Banks – and for maintaining the public's trust in the System as a whole.

This conference is intended to give you the tools to perform your duties, to share ideas and best practices, and to drive home this point: You have accepted very serious responsibilities – to the Banks, to the member financial institutions, and to members of the public who – whether they know it or not – rely on the Federal Home Loan Bank System to provide the financing that helps them buy their own homes.

I quoted Theodore Roosevelt earlier in my comments. Let me close my portion here by quoting another President, a great one, in my unbiased opinion – President George W. Bush.

President Bush has spoken often of the need for a culture of responsibility, throughout society, and particularly in the world of business.

In pursuing an aggressive agenda to strengthen corporate governance, he has placed great demands on business people like those of you in this room.

As he said at a conference on corporate governance, "All people involved in our capitalistic system must assume responsibility for leadership."

As directors of your respective Home Loan Banks, you have willingly accepted, willingly assumed, that responsibility. Our goal here today and tomorrow is to describe, in full detail, what it means to carry out that admittedly heavy responsibility, to explore your roles at your Banks and your relationship with management, and to understand the responsibility you bear within the Federal Home Loan Bank System.

Our goal, then, is to foster the culture of responsibility.

Thank you.

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