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OPENING STATEMENT OF RONALD A. ROSENFELD CHAIRMAN, FEDERAL HOUSING FINANCE BOARD BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

Thank you, Chairman Baker, Ranking Member Kanjorski, and distinguished members of the subcommittee. I appreciate the opportunity to testify on the Federal Housing Finance Board and the Federal Home Loan Bank System. My testimony reports on the condition and performance of the Banks, the operations of the Finance Board, the status of two supervisory actions, and two key regulatory initiatives.

I want to first, however, stress the need for reform of the regulation and supervision of the housing GSEs. Fannie Mae, Freddie Mac, and the 12 Banks are large complex entities. They are important to the nation's housing market and play a vital role in the financial markets. They should be overseen by a single, strong, and independent regulator that has the full arsenal of supervisory and enforcement tools.

The combined assets of the 12 Banks exceed $1 trillion. If the Federal Home Loan Bank System was a bank holding company, it would be the fourth largest bank holding company in the country.

Advances are the Banks' largest asset class constituting 62 percent of assets. The top 10 holders of advances account for 33 percent of the Systems total of advances.

Mortgage purchases are more heavily concentrated than advances. Mortgage loans purchased from members constitute 10 percent of assets. Almost 70 percent of mortgages in the System were purchased from 10 members.

The total capital of the Banks is $45.5 billion or 4.4 percent of assets. Of that total, retained earnings are $3.0 billion.

In the first six months of 2006, the Banks' net income was $1.25 billion.

The Banks have grown in size, sophistication, and risk in recent years. Many of the Banks were not equipped to deal with those changes. They did not embrace and implement appropriate governance and risk management tools. Two examples are the Seattle and Chicago Banks.

The Seattle and Chicago Banks continue to operate under Written Agreements. While the particulars of each case are different, both had a high level of excess stock and both were intent on growing their mortgage portfolios.

The Chicago Bank grew its mortgage portfolio by relying on excess stock. The Chicago Bank's mortgage portfolio grew to 60 percent of assets and excess stock constituted approximately 60 percent of its capital stock.

When the Chicago Bank's earnings declined and dividends were reduced, as one might expect, member requests that the Bank repurchase excess stock accelerated. To conserve its capital, the Bank halted its repurchase of stock. In response, members holding over a quarter of a billion dollars in stock, elected to withdraw from the Bank. That process began a six-month statutory redemption clock. We then had to act decisively and quickly.

There were no easy options. The Chicago Bank, unlike Seattle and the other 10 Banks, had not yet converted to its Gramm-Leach-Bliley capital structure. After reviewing a number of alternatives, we permitted the Chicago Bank to issue subordinated debt. The Bank issued $1 billion in 10-year subordinated debt, which it used to retire a like amount of excess stock that was redeemable with six months notice. That solution provides the Chicago Bank's new management team time to work through and resolve the Bank's financial issues.

We have learned from our supervisory experiences. We have also increased supervisory staff and upgraded our risk modeling technology. We now have the resources to better monitor risk and the wherewithal to take early and resolute action when problems emerge.

We have also taken a number of important regulatory actions. One of those is our rule requiring the Banks to register with the SEC. All 12 Banks are now SEC registrants. Investors, other Home Loan Banks, and the public now have a full and fair view of the financial condition and performance of each of the Banks.

A second regulatory action is our proposed rule on retained earnings and excess stock. In April of this year, the Finance Board issued for public comment a proposed rule to strengthen the capital composition of the Banks. We are analyzing the 1,066 comments we received and are taking an open-minded and cautious approach to the final rule. We will be guided by some fundamental principles.

Specifically,

- We will do nothing to impede the good business judgment of the Banks;

- We will not materially alter the value of membership in a Bank; and
- We will respect lawful actions that were previously taken.

Speaking only for myself, some commenters made valid points and there is room for movement on several important issues.

I want to be clear. I will never be apologetic about capital. While the capital level of the Banks exceeds the 4 percent statutory minimum, the composition of the Banks' capital needs to be strengthened. That is the purpose of our proposed rule.

Some comments state that our proposed rule is contrary to statutory intent of Gramm-Leach-Bliley and that we have exceeded our regulatory authority. We strongly disagree. The intent of Gramm-Leach-Bliley was to stabilize and strengthen the capital of the Banks. Our proposed rule does exactly that. The rulemaking is fully consistent with our regulatory authority and is an exercise of our regulatory duty. It is our duty to ensure the financial safety and soundness of the Banks. A duty entrusted to us by this Congress.

Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, thank you for the opportunity to report on the condition of the Bank System and the Federal Housing Finance Board. I will be happy to respond to any questions.

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