TESTIMONY

OF DAVID HAYES

ON BEHALF OF

THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

BEFORE

THE FEDERAL HOUSING FINANCE BOARD

Chairman Korsmo and other members of the Federal Housing Finance Board, my name is David Hayes and I am President/CEO, Security Bank, Dyersburg, TN. I also serve as Vice Chairman of the Independent Community Bankers of America and Chairman of ICBA's Federal Home Loan Bank Task Force. I am here today to share with you the perspective of ICBA about the "Report of the Horizontal Review of Board Governance of the Federal Home Loan Banks" recently issued by the Federal Housing Finance Board, and the community bank perspective on Federal Home Loan Bank governance issues in general. My comments are based on our initial review of the report and we would be pleased to share with you any additional thoughts we develop after a more complete review.

Like the vast majority of ICBA members, Security Bank is a Federal Home Loan Bank member. We hold membership in the Federal Home Loan Bank of Cincinnati. Like other ICBA members, we have found that the ability to borrow advances is extremely important to our ability to offer our customers residential mortgages and other loan products.

We thank the Federal Housing Finance Board for undertaking a governance review of the Federal Home Loan Banks and for holding this hearing to discuss the review's report. A safe and sound Federal Home Loan Bank System is vitally important to community banks. We recognize that an important part of safety and soundness of any institution is a well functioning and engaged board of directors. The Federal Home Loan Banks are no exception.

As we all know the Federal Home Loan Banks are unique financial institutions and therefore have a unique corporate and governance structure. Congress has given the Federal Home Loan Banks a nontraditional board structure which calls for a certain ratio of director seats set aside for elected member representatives and a certain ratio for appointed representatives of the public interest. We see this structure as appropriate to the FHLBanks' function and purpose.

Congress had an opportunity to review and make changes to the governance structure several years ago when it passed the Gramm-Leach-Bliley Act of 1999. While Congress chose to make some major changes to the System, such as to its capital structure and member stock purchase requirements, it left in place its guidance regarding the allotment of board of director seats. The Federal Housing Finance Board's report notes concerns expressed during interviews regarding statutory and regulatory standards governing the election and appointment of directors. The report suggests that changes to the statute or regulations would be better made on a comprehensive rather than piecemeal basis. ICBA sees no need to seek comprehensive changes at this time, particularly since Congress had the opportunity to address these issues so recently.

Some of those interviewed expressed concern that the current formula for determining votes favors smaller members over larger members because limits are based on the average number of shares of Federal Home Loan Bank stock required to be held by all members located in a state as of record date. It is not that long ago that community banks regularly complained to ICBA that they could not get their members elected to Federal Home Loan Bank boards because of larger long-time members.

We think the current formula for selecting directors, both elected and appointed, remains appropriate for the unique mission of the Federal Home Loan Bank system and its cooperative structure. From our observations, the ability to get elected is strongly tied to the ability of member institutions to organize on a statewide basis to stand behind a single candidate per director seat.

We would have concerns that the largest Federal Home Loan Bank users would likely dominate their Federal Home Loan Bank both through governance and through their influence as dominant customers if they were able to vote all their stock. Not only do we see this creating safety and soundness and board independence issues, but also it would make it far more difficult for community financial institutions to have a voice in their respective districts. We believe this is contrary to the wishes of Congress, which expanded community financial institution access to Federal Home Loan Bank membership and advances in the 1999 Act. Congress gave the Federal Home Loan Bank system a cooperative structure. In a cooperative it is important to give all members an opportunity to be represented, regardless of size and the amount of advances they borrow.

We continue to support the appointment of knowledgeable and engaged public interest directors who are able to provide a unique community perspective. We encourage the FHFB to appoint these directors in a timely manner so as to ensure that they are able to begin serving as directors at the start of the year so they can fully participate in new director training. Some have suggested that the FHFB should attempt to finalize appointments in the December prior to the start of new full terms and we find merit in this goal.

ICBA is also concerned about the suggestion that Federal Home Loan Bank directors, management and employees be allowed to influence director elections. Some argue that these people are in a position to be informed about whom among director candidates may have the best skill set to be a director. Candidates from larger institutions often have desirable experience or expertise in interest rate risk management and it is assumed that if current directors, management or employees supported such director candidates, it would be to the benefit of the Federal Home Loan Bank. We believe any possible benefit would be overshadowed by a direct conflict of interest, particularly when the candidate, if elected, can influence the compensation of Federal Home Loan Bank employees who sought his or her election. In the current environment of increased emphasis on corporate ethics, this is not a path the Federal Home Loan Banks should go down.

If the FHFB sees that the Federal Home Loan Bank directors are lacking needed expertise in interest rate risk management and use of derivatives and other more complex financial and risk management tools, the FHFB should strongly consider this need when appointing public interest directors.

The FHFB has conducted a new director orientation program that we believe is a very valuable program. We encourage the FHFB not just to continue it, but to enhance it to address issues identified in this review. We see the program as an important way to ensure that new directors are given needed training in a uniform manner.

We also support the FHFB's plans to enhance its examination procedures. The report contains a number of good suggestions that do not require changes in the statute or regulations but can be addressed as part of a Federal Home Loan Bank's overall safety and soundness examination. For example, identified weaknesses in the internal audit function are certainly a safety and soundness issue that should be discussed in the examination. As part of the examination, board minutes can be reviewed by FHFB examiners to make a determination of how well management is communicating with board members and how the directors are considering issues identified by the FHFB that demonstrate board effectiveness.

The issuance of this report itself is an important first step in communicating to the Federal Home Loan Banks and their directors ways to improve governance. The FHFB's plan to prepare a booklet on board governance for directors is another valuable step. In our view, the FHFB has an important role to play in enhancing Federal Home Loan Bank governance and we encourage you to do so, through guidance and examination rather than regulation and legislation.

Thank you for giving ICBA the opportunity to testify today and I'll be happy to answer any questions you have.