

Statement For The Record
Of the
National Association of Home Builders
Before the
Federal Housing Finance Board
On
Corporate Governance of the Federal Home Loan Banks

January 23, 2004

I. Introduction

The 215,000 member firms of the National Association of Home Builders (NAHB) appreciate the opportunity to present the association's views on the governance of the Federal Home Loan Bank (FHLBank) System and related issues. NAHB commends the Federal Housing Finance Board (Finance Board) for arranging this timely dialogue to gather information about corporate governance practices and to receive recommendations to strengthen corporate governance at the FHLBanks.

It has been more than two years since Enron's collapse and more than a year since the landmark Sarbanes-Oxley reform legislation. NAHB concurs with Finance Board Chairman Korsmo's observation that in light of the current high level of attention being paid to the management and operations of government-sponsored enterprises, it is appropriate for the FHLBank System to take stock of where it stands on the critically important topic of corporate governance and responsibility.

II. Importance of the FHLBank System

NAHB views the FHLBank System, along with the other housing-related government-sponsored enterprises (GSEs), as fundamentally important components of the nation's housing finance system. The housing-related GSEs are American success stories. They have brought enormous benefits to home buyers, renters and the housing finance system. These include:

Reliable and stable flow of mortgage credit – The linkage that the FHLBanks and other housing-related GSEs provide to the national and international capital markets sustains the flow of capital to housing, even under changing economic conditions. While the economy has undergone major shocks over the past decade, home buyers have experienced no interruption in the availability of mortgage credit.

Elimination of regional disparities in interest rates – The GSEs provide a nationwide market for mortgage funds, a key factor in the elimination of regional disparities in the availability and cost of mortgage credit, which occurred regularly before the housing-related GSEs came on the scene. The cooperative and regional structure of the FHLBanks has been a longstanding and significant force in normalizing mortgage borrowing costs. Today, interest rates in conforming mortgage markets around the country vary by no more than 10 basis points.

Cushion against local economic downturns – When regional economies begin to slow, some participants in the mortgage industry have restricted credit or abandoned markets in search of opportunities elsewhere. This is not the practice of the GSEs. They maintain a presence in all markets under all economic conditions, cushioning the impact of local or regional declines in economic activity. The advances and mortgage purchase programs of the FHLBanks are a particularly important bulwark in this regard.

Market innovation – The GSEs have brought innovation to the mortgage markets to address a broad range of borrower and investor preferences. The FHLBanks stand out in this area by virtue of the programs that are stimulated and supported by the Affordable Housing Program (AHP) and the Community Investment Program (CIP).

Expansion of homeownership and rental housing opportunities – The housing GSEs have made significant strides in expanding homeownership opportunities and increasing the supply of affordable rental housing in underserved areas. For example, each of the 12 FHLBanks contributes at least 10 percent of its annual net earnings to its AHP to subsidize the cost of housing for very low-income and low- or moderate-income owner-occupied and rental housing.

Reduction of mortgage interest rates – The impact of the housing-related GSEs on mortgage borrowing costs is well documented. The FHLBanks have done their share by passing through their advantageous borrowing rates for use in member loan programs. Further rate reductions are provided through the subsidies of the AHP and CIP.

In addition, the home building industry, which is made up largely of smaller companies that do not have direct access to the capital markets through stock or bond issues, relies heavily on the member institutions of FHLBanks for financing to produce homes. NAHB believes the FHLBanks play a vital role in providing liquidity to community-based institutions that specialize in housing production finance, a factor that is increasingly important during a period of rapid changes in the financial services sector.

NAHB commends the Finance Board for continuing to open new approaches for the System by approving new programs through which FHLBanks can achieve their housing

and community development finance mission as housing needs and financial markets shift and evolve.

III. FHLBank Boards of Directors

The FHLBanks are charged with the statutory mission to provide financial products and services that support their members' financing of housing and community lending. FHLBank boards of directors are responsible for ensuring that their institution's activities fulfill the mission in a profitable as well as safe and sound manner. Statutory and regulatory changes have expanded the types of collateral that FHLBanks may accept to secure member borrowings and have established more rigorous and complex capital requirements for FHLBanks. In addition, the FHLBanks are dealing in increasingly complex financial transactions as they fund and hedge their activities. As a result, it is extremely important that the boards of directors of these institutions comprise individuals with the knowledge, experience and ability to understand and competently oversee and direct the activities and operations that are undertaken. A diverse governing board of directors that is well-balanced in knowledge and expertise in the full range of FHLBank issues and activities is imperative to making informed, sound judgments in fulfilling the duties of the board, including monitoring risk management activities of the FHLBank's executives. Therefore, we recommend that the selection of all appointed FHLBank directors continue to be based on a diverse range of criteria that includes an understanding of financial transactions and risk, particularly housing and housing finance-related issues.

In the recently published *Report of the Horizontal Review of Board Governance of the FHLBanks*, the Finance Board notes that a common deficiency of the FHLBank boards is in the knowledge and skills of directors and the training provided for them. The report also mentions concerns about the degree to which appointed directors possess banking and financial risk management experience. As you are aware, NAHB members have a long history of active participation on FHLBank boards. We believe that their knowledge and experience have enabled them to contribute significantly to their individual boards. For example, as builders and developers, NAHB members are regularly involved in complex financial transactions. Home builders have extensive experience in operational risk, as well as credit and interest rate risk through their involvement with financial and business management and the funding of complex housing production projects. NAHB has no doubt that the concerns raised in the Finance Board's report will be ameliorated if you to continue to appoint a significant proportion of individuals with such experience and knowledge as directors of the FHLBanks.

NAHB further believes that it is extremely important that the boards of directors of a FHLBank fully reflect the diversity in size and geography of the district's members. The ability of FHLBanks to support the housing finance efforts of smaller, community-based institutions throughout the district could be compromised if a FHLBank were controlled by a few large members. As mentioned earlier, home builders rely heavily on smaller, community-based institutions for housing production credit, so NAHB is strongly

interested that these institutions have a representative voice in the governance of their FHLBank.

IV. Governance-Related Issues

Capital Requirements

NAHB supports a risk-based capital framework for the FHLBank System. The Gramm-Leach-Bliley Financial Services Modernization Act's provisions for establishing such a capital regime for the FHLBanks allows the System to have greater flexibility and effectiveness in achieving their housing finance mission in a safe and sound manner. NAHB believes it is extremely important that the new capital regulations, which are now being implemented, facilitate such flexibility while avoiding the chronic overcapitalization that has historically characterized the FHLBank System.

We commend the Finance Board's efforts to incorporate "state-of-the-art" concepts in the capital rules and, in general, we support the approach. However, we urge the Finance Board to continue to review the risk-based capital components through a variety of business cycles and market conditions in order to ensure that the FHLBanks are not required to hold excessive levels of capital. Such monitoring is needed in order to maximize deployment of resources to mission-related programs instead of reserves. Excessive capital charges prevent FHLBanks from offering member mortgage purchase programs or creative new product initiatives to assist underserved markets. Overcapitalization also puts the FHLBanks at a competitive disadvantage vis-à-vis the other housing-related GSEs, unnecessarily retarding the System's contribution.

Financial Disclosure

NAHB supports comprehensive, relevant and appropriate standards of financial disclosure for all GSEs. We believe that such standards are not incompatible with their mission. In fact, enhancements to the financial disclosures of the GSEs can contribute to the public's confidence in the transparency of the organizations in particular, and financial markets generally. It is also possible, however, that changes in GSE disclosure requirements can impose costs on the GSEs that would feed through adversely to the price of credit provided. As the FHLBank System's regulator, it is the Finance Board's obligation to carefully scrutinize and understand the impact of SEC registration on the operations and activities of the FHLBanks. NAHB is concerned that a number of issues or questions on such potential impacts either have not been fully analyzed or the results have not been publicized.

NAHB believes that a thorough and in-depth analysis is required to accurately assess the merits and costs of SEC registration, including the impact on housing credit and affordable housing. Therefore, NAHB urges the Finance Board – either independently or in conjunction with the SEC, and other interested industry groups – to undertake a comprehensive review of SEC registration prior to altering FHLBank disclosure rules. In particular, NAHB requests that the review evaluate the potential ramifications of any new

disclosure requirements on the cost of housing finance and the availability of affordable housing. Furthermore, NAHB requests that the Finance Board publish the results of the study, and provide an opportunity for public review and comment before initiating further rulemaking proceedings.

Collateral for Advances

One of NAHB's top priorities is to expand the sources of financing for housing production loans – specifically residential land acquisition, land development and construction (AD&C) loans. In the course of this work, NAHB has noticed that even though these loans qualify as eligible collateral for FHLBank member advances, they are seldom used as such. Anecdotal evidence derived from talking with several FHLBank members suggests that residential AD&C loans are not used as security for member advances because their FHLBank will not accept such loans as advance collateral, or the reduction from market value to collateral value for these loans is prohibitive.

NAHB has obtained data on AD&C lending from the Office of Thrift Supervision (OTS) that demonstrate that residential AD&C loans have performed exceptionally well historically relative to other loans in thrift portfolios, and that the loss experience on single family construction loans has been very close to the very low rate on home mortgages. (A statistical package accompanying this statement contains a set of charts along with the underlying data showing comparative historical information on thrift loan performance.)

NAHB believes the risk profile of residential AD&C loans, particularly single family construction loans, makes them excellent collateral for FHLBank member advances. NAHB believes these housing production loans are a true mission-related asset in addition to being a permissible form of real estate-related collateral under the Federal Home Loan Bank Act. However, Finance Board regulations require a FHLBank to comply with the new business activity notice procedures prior to accepting other real estate related collateral, such as AD&C loans. We therefore request that the Finance Board specifically authorize FHLBanks to accept residential AD&C loans as collateral for member advances and exempt such loans from the new business activity notice procedures.

Affordable Housing Program

NAHB strongly supports the Affordable Housing Program and views it as a critical resource for addressing affordable housing needs. NAHB also supports the homeownership set-aside program within the AHP, which gives FHLBanks additional flexibility to respond to the needs of their district.

The statute creating the AHP gives priority to non-profit sponsors. This has inhibited participation by for-profit builders. We recognize that the Finance Board has taken some steps in the regulatory process to allow more opportunity for for-profit builders to

participate in the AHP. We commend the Finance Board for these efforts and hope that additional adjustments can be made.

For-profit builders have demonstrated the ability to produce housing of higher quality and lower cost than that produced by non-profits. The exclusion of for-profit sponsors needlessly works against the AHP's goal of providing housing most efficiently in markets where the need is greatest. A number of builders have found ways to participate in the AHP, but many still are excluded unnecessarily.

NAHB supports recent initiatives to add flexibility to the AHP such as the amendments made in October 2001 and more recently in September 2002. We hope that the Finance Board will continue to look for ways to grant greater flexibility to the directors of the FHLBanks to address housing needs in their areas.

In addition, we urge the Finance Board to ensure that the AHP is compatible with other federal housing programs such as the HOME, Community Development Block Grant (CDBG) and Low Income Housing Tax Credit (LIHTC) programs. The Federal Housing Administration's multifamily mortgage insurance program is another critical source of financing for affordable multifamily rental housing. NAHB eagerly awaits the implementation of the American Dream Downpayment Act, which authorizes \$200 million annually to assist low- and moderate-income home buyers with downpayment and closing costs, providing grants of roughly \$5,000 to an estimated 40,000 home buyers annually. Through the AHP, the FHLBanks play an integral role in implementing the Administration's federal housing policy and we look forward to their continued involvement and innovation.

Affordable Housing Program Advisory Councils

Another recommendation NAHB has relates to the AHP Advisory Councils. Currently each of the FHLBanks is required to establish an Advisory Council to provide advice on ways in which the FHLBank can better carry out its housing finance and community lending mission. According to the Federal Home Loan Bank Act and the Finance Board's implementing regulations, a FHLBank is required to solicit nominations and appoint Advisory Council members in a manner that ensures the membership is as broad and participatory as possible, and ensure that the membership includes persons drawn from a diverse range of organizations. However, NAHB notes that the law and regulations are written in such a way that could leave the impression that the Advisory Councils should comprise only community and non-profit organizations. We point out that the Finance Board issued an opinion in 1997 clarifying that Advisory Council membership is open to all professionals with expertise in affordable housing issues. However, historically and presently, the overwhelming majority of members of FHLBank Advisory Councils are representatives of non-profit or government organizations. While these individuals certainly bring a valuable perspective on community housing conditions and needs to Advisory Council deliberations, NAHB believes the Advisory Councils would benefit from the involvement of representatives of private, for-profit housing providers. For-profit builders produce most of the nation's affordable housing. Through

hard-earned experience, they have accumulated valuable information on innovative and cost-effective building design, materials and techniques, as well as fresh points of view on important housing policy issues.

The FHLBank Advisory Councils play an important role in developing the blueprints used by the FHLBanks in addressing community housing needs. NAHB urges the Finance Board to look for ways to promote a broader range of backgrounds and experience on the Advisory Councils to assist with this critical task.

FHLBank Products and Programs

As mentioned earlier, NAHB strongly believes that the FHLBanks should have sufficient authority, capacity, and flexibility, within the bounds of safety and soundness, to design products and programs to meet the housing finance and community development needs of their districts. One of the defining features of the FHLBank System is the regional structure that allows each of the twelve FHLBanks to offer products and services that are tailored to the economic, housing and membership conditions in their individual areas. NAHB views FHLBank pilot programs as an excellent method for the FHLBanks to develop and test new mission-related products and services to help members pursue specific, and sometimes unique, housing finance needs and opportunities in their districts. NAHB has been a strong and vocal proponent of the pilot programs and we would like to again express our appreciation to the Finance Board for encouraging the FHLBanks to develop and implement these innovations.

We believe pilot programs offer a great opportunity for the FHLBanks to create additional mission-related programs that can advance the housing focus of the FHLBank System while also improving the returns on the FHLBanks' portfolios. The Mortgage Partnership Finance Program (MPF), the MPF's enhancements implemented by the Shared Funding Program, and the Mortgage Partnership Program are prime examples of highly successful and innovative financing programs that began as pilot programs. In fact, we feel the pilots are the best way to increase the portion of FHLBank portfolios invested in mission-related assets.

The FHLBanks should be strongly encouraged to develop and implement more pilot programs. We believe there are many more opportunities for pilots. For example, there appears to be significant opportunities to facilitate lending for residential housing development and construction programs. We also believe that the area of multifamily financing currently has unmet financing needs.

In addition, the FHLBanks should undertake additional products and services, within the bounds of safety and soundness, as part of their regular course of business. For example, FHLBank issuance of letters of credit and encouragement of the establishment and expansion of loan participation networks could serve to broaden their options for improving earnings while providing valuable support to members in mission-related lending.

V. Conclusion

In summary NAHB believes the FHLBanks play a vital role in providing liquidity to community-based institutions for housing finance, a factor that is increasingly important during the rapid evolution of the financial services sector. We appreciate the Finance Board's efforts to maintain and enhance the integrity, relevancy and continued vibrancy of the FHLBank System. NAHB hopes this review of governance will assist in furthering such initiatives, and bolster the System's contributions in meeting the nation's housing finance needs while ensuring continued safe and sound operation. As always, NAHB and its members stand ready and willing to work with you, the FHLBanks and the System members to identify and address challenges and opportunities in housing finance.