

Testimony of
America's Community Bankers
on
Federal Home Loan Bank Governance
before the
Federal Housing Finance Board
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and

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Mr. Chairman and members of the Finance Board, my name is J. Edward Norris, III. I am President, Chairman and CEO of Plantation Federal Bank in Pawleys Island, South Carolina. I am also Chairman of America's Community Bankers' Government Affairs Steering Committee and the past Chairman of the Federal Home Loan Bank of Atlanta. ACB appreciates the opportunity to present its views on ways to enhance the governance of the Federal Home Loan Banks (FHLBanks).

The continued financial health and viability of the FHLBanks is vitally important to ACB members and, ultimately, to American homeowners. ACB members own over half of the stock of the FHLBank System; for many of them it is their single largest asset. In addition, ACB members depend tremendously on the advances provided by their FHLBanks to provide the liquidity necessary to fund their home mortgage lending business. Therefore, ACB commends the Finance Board for taking this initiative.

A review of the FHLBank System's corporate governance is timely for several reasons:

- As the financial structure of the FHLBanks becomes increasingly complex, it is essential to improve the qualifications of directors so that they can effectively oversee the FHLBanks' operations.
- The System's membership and activities are continuing to expand and move in new directions.
- The FHLBanks are implementing new capital plans under the provisions of the Gramm-Leach-Bliley Act.¹
- Policy makers are placing increased emphasis on the importance of good corporate governance to maintain corporate accountability and protect the health of the economy.

ACB recommends that the Finance Board consider several possible ways to improve the qualifications of directors that become members of the boards of the FHLBanks. By making these recommendations we do not intend to criticize any particular boards or board members. However, it is apparent to us that the FHLBank boards would greatly benefit from a process that helps ensure that the directors have the skills needed to properly oversee the increasingly complex FHLBank System.

We also believe that the FHLBanks would benefit from enhanced influence of stockholders that have a substantial stake in the System. Obviously, those who buy a substantial amount of stock and make significant use of the FHLBanks' advances have the most incentive to ensure that the System operates safely, soundly, and effectively.

Public Interest Directors

Under section 7(a) of the Federal Home Loan Bank Act,² the Finance Board appoints at least six directors to each FHLBank. Of these, two must be representatives of consumer or community

¹ Public Law 106-102

² 12 U.S.C. 1427(a)

interests. There are no statutory categories for the other appointed directors, or specific qualifications for those that might be appointed.

In recent years, the FHLBanks have increasingly engaged in sophisticated business activities, including hedging activities and other techniques intended to reduce their interest rate risk. While these techniques are increasingly necessary and can provide great benefits to the FHLBanks, if not skillfully conceived and implemented, they can pose serious risks. The Finance Board recently released a report on FHLBank board governance that found that, “The most common deficiency was in the knowledge and skills of directors and the training provided for them.”³

ACB believes the Finance Board could help remedy this problem by using its current authority to appoint directors who have the financial background to oversee the FHLBanks’ activities designed to reduce their interest rate and other risks. One advantage of this approach – as opposed to a statutory change – is that it preserves flexibility to appoint other types of experts in appropriate numbers as new needs become apparent. ACB was pleased to learn that “the Finance Board is exploring regulatory options with respect to, among other things, experience and expertise requirements for appointed directors.”⁴ ACB supports appointment of such directors for terms of reasonable duration.

ACB is concerned that stockholders’ voices are not always heard and heeded by the boards of the FHLBanks. One way this could be remedied would be to provide for stockholder votes on non-financial institution directors that are currently appointed by the Finance Board. Although giving the stockholders binding authority to vote on appointive director candidates would require a change in the Federal Home Loan Bank Act, current law might permit the Finance Board to appoint directors after stockholders have had an opportunity to vote on them on an advisory basis.

Policy makers may wish to reconsider the statutorily mandated appointment of directors by any government official or agency. In his statement on GSE regulatory reform, Treasury Secretary Snow, stated that, “The Administration is committed to make sure that the directors of publicly-traded corporations like Fannie Mae and Freddie Mac are elected by the shareholders, rather than selected by the President.” While the FHLBanks are not publicly traded, they are – like Fannie Mae and Freddie Mac – owned by private entities, depository institutions. Thus, if Congress decides to eliminate Presidential appointments to the boards of Fannie Mae and Freddie Mac, it should consider eliminating the appointment of FHLBank directors by the Finance Board.

Selection of Directors

The Finance Board’s governance report noted that the formula for determining the number of votes a member may cast in director elections “favors the smaller members and disadvantages the larger members.”⁵ The report states that, “Of the directors who commented on this issue, a

³ Report on the Horizontal Review of Board Governance of the Federal Home Loan Banks, June 2003 (Governance Report), p. 7

⁴Governance Report, p. 22

⁵ Governance Report, p. 21

majority expressed the opinion that the voting formula should be ‘more balanced’ between smaller and larger member.”⁶

ACB has not taken a position on whether larger members should be permitted to vote a greater amount of their shares. ACB recognizes that limitations preventing the largest stockholders from voting all of their shares has been an important feature of FHLBank System governance, and has encouraged broad member participation that has been a hallmark of the System’s cooperative structure.

However, ACB believes that structural changes in the System’s membership over the last 15 years have dramatically diminished representation of active, more qualified System users on the Boards of the FHLBanks. In the past, voting limits on very large stockholders served to limit their board representation and thereby helped to preserve the cooperative culture. Smaller members typically were active users of services and had substantial stakes in the FHLBanks and excellent qualifications. Therefore, elected directors, whether from large or small institutions, had converging knowledge and interests. They tended to be very knowledgeable about their FHLBank’s operations, and were well attuned to safety and soundness considerations.

This situation frequently does not prevail today. System membership has expanded many fold, and today’s average member often has a minimal stock investment and minimal usage of the System. This type of member has made a rational choice to provide a “safety net” or “insurance policy” in the event that liquidity or other financial services are needed, but such members have a smaller stake in the system and its operations than more active users with higher capital investments. Also, some of these newer members buy stock with a focus on yield rather than to capitalize the risks created by the financial services provided to them. Without question, the current prevalence of institutions that view their membership either as an insurance policy or primarily as an investment opportunity has diminished board representation of the System’s more qualified active users and relatively larger investors.

ACB is reluctant to recommend a reallocation of voting rights on the basis of size. We believe that such a change could be divisive and may not adequately address the problem we have identified. Nevertheless, declining board representation by qualified, active System users is weakening governance of the System, both in terms of business management and safety and soundness. The FHLBank System’s most active members have gradually been disenfranchised. Although this has not been by design, the affects on incentives and governance are real.

A potential solution might be to change caps on voting stock. However, the problem is not necessarily distinguished only by relative size. ACB believes that the key fact is that institutions that rely both on dividends and advances have much more at stake in the System than do institutions that take out relatively few advances. We recommend that those institutions that depend more heavily on the System have greater voting power in elections for board positions. In this way, knowledgeable, active users – particularly those that depend heavily on FHLBank advances – will be well represented.

⁶ Governance Report, p. 21

This could be accomplished by adjusting the voting formula to reflect the percentage of an institution's liabilities that are represented by advances. Under this plan, a small member that depends substantially on advances would gain influence, while a very large member that uses a relatively smaller percentage of advances for its funding would not. This should hold true even if the larger member had a larger absolute amount of advances. This change would give institutions with a greater commitment to the System a greater say in its operations, without exacerbating divisions based on size. And, this could be accomplished in a manner consistent with the current system of caps on voting stock.

Payment and Terms of Directors

Congress is now considering changes regarding the compensation and terms of FHLBank directors. Section 617 of H.R. 1375 the Financial Services Regulatory Relief Act of 2003, now awaiting action in the House, would extend the terms of elected and appointed directors from three to four years. The Finance Board's review of FHLBank board governance noted that, "directors stated that it takes six to 24 months to understand the operations of the Bank."⁷ This argues strongly for longer terms for board members. As Congress considers this bill, it should be careful to provide for an orderly transition to the longer terms. Whether or not Congress extends director terms, regulatory changes should be designed to help select better-qualified directors with minimum learning curves.

The other provision of H.R. 1375 that affects FHLBank directors is section 616. This section would eliminate the current limits on board compensation that were enacted as part of the Gramm-Leach-Bliley Act. Eliminating this restriction would provide an incentive to attract and retain directors with the highest qualifications. The Finance Board's study of board governance reports that the limits have led to unintended consequences, such as reduced attendance at board meetings and reduced frequency of meetings.⁸ The study also suggests that the FHLBanks would be unlikely to increase board compensation by large amounts.⁹

Conclusion

We would welcome the opportunity to provide more explicit and concrete recommendations on these important issues in the near future after our members have had a greater opportunity to review and consider all possible solutions.

⁷ Governance Report, p. 24

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