BEFORE THE
FEDERAL HOUSING FINANCE BOARD

HEARING ON
FEDERAL HOME LOAN BANK CAPITAL PLANS

TESTIMONY
OF
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1. Introduction

The Federal Home Loan Bank of Chicago ("Bank") is pleased to present its views to the Federal Housing Finance Board ("Finance Board") at its hearing on Federal Home Loan Bank capital plans. We have submitted written testimony for the record on the points and issues discussed.

On October 29, 2001, the Bank submitted a Capital Plan as required by the Gramm-Leach-Bliley Act and the Finance Board's implementing regulations. This Plan was developed following extensive meetings with Bank members in Illinois and Wisconsin, both in groups and individual sessions, and exhaustive discussion at multiple Committee and full Board meetings of the Bank's Board of Directors. Thus, the Capital Plan represents the will of the Bank's Board of Directors and its members. The Plan was also reviewed by outside experts in regard to its ratings and accounting implications, as well as its fairness to members.

The matters under consideration by the Finance Board are complex and have far reaching implications for the ability of FHLB's to achieve their housing finance mission in contemporary markets. We hope that after the Finance Board considers the Bank's Capital Plan in light of the points addressed in this testimony, it will conclude not only that the Plan is entirely consistent with the law and with the Finance Board's responsibilities as the Bank's safety and soundness regulator, but also that it offers the greatest potential for the Chicago Bank to fulfill its statutory housing finance mission.

2. The Bank's Capital Plan is Safe and Sound

The Bank's Capital Plan is fully consistent with law, the operating goals of its cooperative members, and the principles of safety and soundness. The Plan provides that the Bank will, at all times, be fully capitalized in compliance with its minimum capital requirements, both leverage and risk-based.

The Finance Board has invited comment on the extent to which voluntary stock may be relied upon by a Federal Home Loan Bank in its capital plan to support certain types of Bank assets. The Chicago Bank has a keen interest in this issue since our Capital Plan does not impose a mandatory activity-based stock investment requirement for members providing housing finance to their communities through Mortgage Partnership Finance® ("MPF") Program transactions with the Bank. Our Bank intends to rely on aggregate Bank capital, including mandatory membership stock and voluntary stock, to capitalize MPF assets, and believes that this approach will enable the MPF Program to continue to flourish and, at the same time, always provide the Bank with sufficient capital to satisfy all applicable capital requirements.

The MPF Program, introduced by the Chicago Bank in 1997, has been an unqualified success. The Program, which gives mortgage lenders an alternative to selling their mortgages in the secondary market, has funded over $35 billion of loans to assist approximately 300,000 households finance their homes. Over 320 Federal Home Loan Bank member institutions in 35 states are approved to fund MPF loans. Of those participating members, more than 70% are Community Financial Institutions with assets of less than $500 million. The number of PFI's continues to grow and the portfolios of MPF loans grew 61% last year -- more than three times the growth rate for Fannie Mae and Freddie Mac.

The MPF Program has been widely recognized as a fundamentally important innovation in terms of the services that are offered to Federal Home Loan Bank members. It provides member institutions with a significant alternative to engaging in secondary market transactions with Freddie Mac and Fannie Mae. It has also performed well from a financial perspective to the benefit of the members of the Chicago Bank. Member institutions and the consumers that they serve have benefited from the availability of this alternative secondary mortgage program. From a public policy perspective, we believe that the MPF Program offers significant advantages over the programs offered by other housing finance GSEs, since it allocates most of the credit risk associated with MPF assets to private sector entities. Moreover, the cooperative nature of the Federal Home Loan Bank System, as compared to the public shareholder orientation of the other housing GSEs, provides for a more efficient use of GSE advantages, keeping more of the value added of the mortgage transaction within the FHLB members both as customers and stockholders.

The approach taken by the Bank in the Capital Plan with regard to MPF assets does not pose any threat whatsoever to its ongoing capital compliance or safety and soundness. Any concern that the Bank could be subject to redemptions of voluntary stock that could cause it to suffer adverse financial consequences or cause it to fail to satisfy its minimum capital requirements cannot be supported by the facts or the law. Whether stock that members hold is required or voluntary, it simply cannot be redeemed or repurchased if such an action would cause the Bank to fail to meet its minimum capital requirements. Under those circumstances, the Bank can never become capital deficient because of such redemptions or repurchases.

To the extent that the Bank were unable to add additional capital, whether in the form of mandatory stock, voluntary stock or retained earnings, the Bank would manage or curtail its MPF Program activities so that it continued to remain in compliance with its minimum regulatory capital requirements. Moreover, under the Bank's Capital Plan, the Bank, like other Federal Home Loan Banks, has the flexibility to increase its membership and/or activity-based stock investment requirements within the ranges set forth in the Capital Plan or to seek approval from the Finance Board to increase those ranges. Thus, if needed, it could promptly issue substantial additional required stock to members to satisfy its capital requirements. Moreover, under the Gramm-Leach-Bliley Act, the Bank has a call on all members for any additional stock needed. Thus, sufficient capital as a mandatory matter is guaranteed by the Gramm-Leach-Bliley Act.

An important element of the new law and the Bank's Capital Plan is that the members own the retained earnings of the Bank and therefore are at risk to the extent of their investment. Therefore, it is the members that should decide: (1) what overall return is appropriate and on what basis they should share in the aggregate risks of the Bank; (2) how to share in the obligation to maintain the capital of the Bank; and (3) in what manner they wish to encourage the development of new products and services. Thus, member choice of how to share benefits and risks of membership are kept in the cooperative and strengthen it.

When you consider all of the protections built into the Capital Plan together with the statutory protections, the proposed Capital Plan ensures that the Bank continues its 70-year history of safety and soundness.

3. Our Members Want the MPF Program to Continue to Flourish and a Capital Plan that Supports this Goal

Our member institutions have whole-heartedly supported the development, implementation and operation of the MPF Program. This member commitment included a very significant investment of Bank earnings from 1996 to date to create a Program, which has clearly demonstrated member value already. Its future value to the members is even greater.

In approving the Capital Plan, the Board of Directors, expressing the will of the members, chose not to require a mandatory stock purchase as part of an MPF transaction. Rather, the Board of Directors chose to rely on the Bank's overall capitalization to support the MPF Program, in part, because the Bank (like many FHLB's) has a long tradition of members holding voluntary stock, and in part, because the only way capital actually works is that all capital protects against all risks, as further discussed in Section 5. Voluntary capital has historically provided capital support for the products and services that its members have wished to obtain.

The Bank’s canvassing of its members in connection with its Capital Plan during 2001 underscored the members’ strong support of the Bank’s continued reliance on voluntary stock to capitalize its activities and the continued expansion of the MPF Program. This is consistent with the Congressional movement of the FHLB's from a mandatory to a voluntary system in general.

The Bank took these member preferences and its obligation to meet its regulatory capital requirements into account in developing the Capital Plan. Thus, the Plan, as permitted by the law, is a demonstration of the will of the members and reflects the results of individual and group meetings with the Bank’s members.

It is instructive to note that historically, of the Bank's 860 members, there has been exactly one member withdrawal in the 13 years of voluntary membership: Wauwatosa Savings & Loan Association in 1989, which has since rejoined. In addition, there have been no minimum capital compliance violations during that period. This Bank's members have always voted with their capital to support their desire for Bank services, and for MPF in particular.

4. <u>The Importance of the Capital Plan to the Future of the MPF Program</u>

Members clearly tell us that the continued growth of the MPF Program would be very adversely affected if the Bank's Capital Plan included mandatory purchases by the member of Bank stock linked to the member's MPF transactions. The interests and preferences of the Bank's members are best served by having a Capital Plan that allows the MPF Program to continue to grow to create a better American housing finance system for the benefit of all members, consistent with the safe and sound operation of the Bank, without imposing undesirable mandatory stock purchases. Thus, our members will determine the future of the MPF Program based on their voluntary individual decisions that result in the purchase of voluntary stock in the Bank. If they do not wish to capitalize the MPF Program, it will not grow and in that case, it should not grow. We believe, in short, in member choice.

In the current secondary mortgage market, members have the option to sell mortgages to, or swap mortgages with, other GSEs without engaging in any purchase of stock of either entity, or any commitment whatsoever to hold such stock for a specified period of time.

Bundling the mortgage sale decision with a mandatory stock purchase makes dealing with the MPF Program much more complex and uncertain, subject to a larger set of unknown economic variables, which will make it a more costly and less attractive financial opportunity.

This "bundled" MPF product would likely persuade members, as a matter of the pure economics of the transaction, to retreat from participation in the MPF Program. The MPF Program would subsequently face a significant risk of losing the member support, scale and momentum that it needs to successfully compete, serve the public interest (or accomplish an eventual transition to securitization). Compelling a member to choose between a “bundled” MPF purchase versus an “unbundled" secondary mortgage market opportunity will put MPF at a major competitive disadvantage and reduce its ability to provide the positive economic effects to the secondary market that increased competition always brings.

This huge cost would be matched by zero gain in safety and soundness. The secondary mortgage market is a national business with national pricing and MPF offers members uniform pricing across FHLB's, as all members, large and small, desire. To bundle the MPF transaction with stock, however, causes the price to change by FHLB, reducing its competitive benefits on the secondary market.

5. Aggregate Bank Capital Protects All Assets

Under the Bank’s Capital Plan, required stock, voluntary stock and retained earnings are all equally available to ensure that the Bank continues to meet all its regulatory capital requirements. This approach is consistent with applicable law and regulations, but more importantly, it is essential to the nature of capital. All capital must be available to cover all risks. Every member's capital is at risk for all other member's transactions. If this is not true, it is not capital, but merely a compensating balance. As we understand the Seattle Bank’s approved capital plan, it relies on voluntary stock to capitalize a portion of its advances and to capitalize its unsecured short-term investments. This is a partial recognition of the principle just stated.

Neither the statute nor its implementing regulation requires the separate capitalization of MPF or any assets with mandatory stock, as opposed to the aggregate capitalization of all assets with stock which, under the Gramm-Leach-Bliley Act, is fully permanent and mandatory in the aggregate. Once the Finance Board determines, as we believe it has, that transactions may appropriately be capitalized with voluntary stock, it is a question of policy and safe and sound operation as to where the line between voluntary and required stock should be drawn. We believe that the Bank’s membership, as a whole, should determine the level of support for the MPF Program and the extent to which voluntary stock should be used to capitalize the Bank’s MPF asset portfolio. It is a matter for individual member choice -- while being mandatory in the aggregate.

6. <u>In a Cooperative, Different Members Contribute Different Things</u>

There has been much discussion about how best to preserve the benefits of the "cooperative" nature of the Banks. A true cooperative is a voluntary association of members that can achieve business and economic advantages when the participants pool or coordinate their access to larger and more efficient markets or resources. The voluntary stock aspects of the Bank's Capital Plan are fully consistent with the true nature of a cooperative. For example, mutual associations, such as thrift institutions, have depositors and borrowers. Depositors contribute "member capital" through their deposits, but those deposits are not required to and cannot logically directly correspond to the amounts that specific depositors may choose to borrow. The cooperative structure of ownership, much like modern theories of portfolio management, is based on concepts of aggregate risk being offset by aggregate investments. The approach taken by our Capital Plan will communicate clearer and more immediate operating and investment signals from the members to the Bank's Board of Directors and management than any mandatory system and is more consistent with the cooperative structure of the Bank as a voluntary association for mutual benefit.

We believe that a mandatory "activity-linked" stock purchase requirement creates a strong psychic predisposition to withdraw such stock whenever the member chooses to cease the activity. Indeed, a strong psychological contract seems to be created: "When I cease the activity, you will give me back my stock." Voluntary stock does not suggest the same transient nature of a member's investment. In a voluntary cooperative association, members purchase stock because they want the organization to grow, and they actually want to own the stock because it supports the organization's operations and provides an attractive return. In many ways, such capital is of a higher quality than an activity-based capital investment because it has to be "earned" from members. This seems to us to constitute a sounder financial foundation than one which adheres to mandatory activity-based capitalization structure with its concomitant psychological contract.

In fact, excess reliance on activity-based stock can be detrimental to a cooperative's safety and soundness. An example of this may be found in the experience of the Farm Credit System in the mid-1980's. During that period, as the financial health of the Farm Credit System worsened, financially strong Farm

Credit System borrowers left the System, in part because they feared the loss of their stock investment. As those borrowers paid down their loans, they received their capital investment back, thereby reducing the cushion remaining to absorb losses in the cooperative and worsening its financial condition. Note that the strongest borrowers by definition have the greatest ability to move their borrowings. Thus, "activity based" requirements in times of stress create severe adverse selection for the institution. While our Capital Plan, as required by law and regulation, prevents the redemption of <u>any</u> stock – mandatory or voluntary - if the Bank would not be in compliance with its minimum capital requirements, we believe that the implied psychological contract of mandatory activity-based stock makes such stock less attractive as a long-term capital cushion than voluntary stock.

7. <u>Conclusion</u>

The purpose, structure and nature of regulation of the Federal Home Loan Banks should, within the parameters of the law, correlate to their financial history and performance. In that regard, it is instructive to note that in the 70 years that the Federal Home Loans Banks have so effectively and efficiently served their mission to promote housing finance, none has ever experienced a loss on any advance to a member. Similarly, regulatory problems, enforcement actions and capital deficiencies in the Bank System have been <u>de</u> <u>minimus</u>, to the extent that they existed at all. In our view, the Finance Board should implement the requirements of the law in a manner that reflects the long history of prudent operation and efficient capital management that the Bank System has demonstrated. There is no compelling reason to restrain the activities of any of the Federal Home Loan Banks through the imposition of overly restrictive capital requirements regarding the permissible components of Bank capital that are not required by law.

In summary, we believe that our Bank's Capital Plan:

- is absolutely safe and sound;
- will facilitate an environment in which the MPF Program can realize its potential as a meaningful GSE competitor and a major contribution to the FHLBs' housing finance mission;
- reflects the fact that aggregate capital is required to balance the risk created by aggregate assets;

- preserves and enhances the cooperative nature of the Bank by correlating the activities of the Bank with its ability to attract the voluntary participation of its members; and
- preserves and enhances member choice.

Thank you for the opportunity to present the views of the Federal Home Loan Bank of Chicago. I welcome the opportunity to answer any questions that you may have.