Testimony of

Federal Home Loan Bank of Atlanta

on

Federal Home Loan Bank Governance

before the

Federal Housing Finance Board

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Community Bank of Tri-County
Waldorf, Maryland

and

Chairman, Board of Directors
Federal Home Loan Bank Atlanta
Atlanta, Georgia

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Mr. Chairman and members of the Finance Board, my name is Michael Middleton. I am Chairman and President of Community Bank of Tri-County in Waldorf, Maryland. I am also Chairman of the Federal Home Loan Bank of Atlanta's Board of Directors. On behalf of the board of directors and our members, I appreciate the opportunity to present the Atlanta Bank's views on the importance of governance of the Federal Home Loan Banks (Banks) in an evolving financial world.

As a Federal Home Loan Bank director for over eight years, I know how important it is to understand the Bank's operations and general financial management in order to effectively oversee management's business strategies, program development and risk management. This perspective also helps me appreciate how much the Bank System has changed during the past decade. When I joined the Atlanta Bank's board on January 1, 1996, our Bank had $30 billion in assets and $13 billion in advances. Today those volumes have grown to approximately $116 billion and $85 billion, respectively, and the size of the overall system has grown at a significant pace. Perhaps more importantly, the level of financial sophistication and complexity associated with running a Bank have increased at an even greater pace. Those trends have profound implications for governance of the Federal Home Loan Banks.

At the same time, we must remember that the Banks are organized as cooperatives, a structure that I believe still best serves our members and the American public. Mr. Chairman, the Bank System is extraordinarily important to my institution and to 8,000 other local financial institutions and the communities we serve. I commend you and the other directors for holding these hearings and for taking your responsibilities seriously as you begin to look at the governance of the Banks.

It is our hope that this exercise is the beginning of an in-depth study and analysis of the Banks' governance and related issues. The Federal Home Loan Bank of Atlanta strongly urges the Finance Board to undertake this review in a manner that strengthens an already sound Bank system. Rather than simply adopt general corporate governance practices for the Federal Home Loan Banks, we believe it is important that the Banks' governance rules maintain and strengthen their statutory structure and mission. Mr. Chairman, the course you have laid out can be a great start toward a very productive result.

<u>FHLBank Atlanta Governance</u>

The Atlanta Bank is committed to cooperating with the Finance Board's process and is committed to implementing and maintaining the best practices regarding its corporate governance. Our commitment is based on a very simple premise: robust corporate governance is critical to achieving our mission.

The Bank's policies and standards apply to our entire organization. Board members, officers and employees must comply with explicit codes of conduct. While the board operates entirely independent of the Bank's management, it is markedly different from the typical corporate board structure. Federal Home Loan Bank directors are elected and appointed in a manner dictated by statue and regulation. This statutory structure could be viewed as inconsistent with what is considered to be best practices for traditional corporations regarding director independence. The appointed directors are such an example. While independent of the Bank's management, these appointed directors do not meet the definition of independence applicable to public companies, in that they are appointed by the Bank's regulator. Similarly, elected directors are shareholders who avail themselves of the Bank's products and services, yet are asked to serve a broader purpose as directors.

While the composition and structure of the Federal Home Loan Banks' boards of directors may be perceived to be in conflict with traditional corporate governance standards, we should remember that this structure has worked relatively well for over 70 years. The dynamic relationship between the industry and public interest directors has contributed to the achievement of the Banks' public mission. Changes should be considered, but only cautiously, and with full analysis of the potential consequences.

The Atlanta Bank's board of directors and management has worked closely to develop operational guidelines and mechanisms to ensure that appropriate governance policies and tools are part of the Bank's corporate culture. As the world of finance continues to evolve and the Banks apply new financial standards to their operations, the boards' governance responsibilities must evolve as well. Our Bank has made available, on its web site, detailed information regarding its governance procedures, including its "Governance Documents & Practices."

To help ensure that our board and management continually review the Bank's governance practices, the board recently established a new Governance Committee. The committee is charged with educating, advising and assisting the board in development and implementation of best practices with respect to corporate governance.

Issues For Consideration

There are a number of issues regarding the Banks' corporate governance that we believe warrant additional consideration. These include:

- Director Qualifications
- Director Financial Conflict Standards
- Director Compensation
- Director Terms
- Industry Director Elections
- Public Interest Director Appointments

There are many factors that go into producing the most effective Federal Home Loan Bank board of directors. Initially and ideally, such a board comprises a diversified membership with a broad base of knowledge that includes financial, banking, housing and community development, as well as general corporate governance expertise. Even if it were reasonable to expect the various newly-elected and appointed directors to embody these attributes, it would be unreasonable to expect that each director would have an in-depth knowledge and understanding of the Federal Home Loan Bank System. Attaining such knowledge requires time and hands-on experience at the Banks. In short, we recognize that developing standards and rules to achieve the most effective and efficient corporate governance for the Banks will require balance and managed expectations.

Director Qualifications –

Clearly, the more finance and housing related experience and knowledge a director has when he or she is elected or appointed, the better positioned that director will be in making an immediate contribution to his or her Bank. As the Banks engage in more complex financial activities, it is equally clear that specific types of expertise can be of great benefit to the boards of the Banks.

Mr. Chairman, the Finance Board recognized this fact when, on March 19, 2003, it published in the Federal Register a proposed rule requiring at least one public interest director to have a background that demonstrates "an understanding of the risks faced by a particular Bank because of its investment and financing activities." The Atlanta Bank supports the appointment of directors that, in addition to their other qualifications, have a background or expertise that would strengthen the board's ability to analyze and manage the risks faced by a Federal Home Loan Bank. Areas such as interest rate risk, market risk, and the risks arising from options associated with a Bank's financing and investment activities must be addressed at the board level. In fact, we believe that <u>all</u> directors should understand the Bank's business activities, and the risks associated with those activities.

The majority of each Federal Home Loan Bank's directors are elected by its members. While these directors generally have solid foundations of financial knowledge, their initial understanding of the Banks and some of the Banks' activities can vary greatly. In addition to seeking the most qualified directors, both elected and appointed directors must also be provided with regular educational opportunities beyond the initial orientation session (including, among other things, education regarding Bank programs, accounting standards, professional responsibility and market trends).

Director Financial Conflict Standards –

Chairman Korsmo correctly noted in his opening comments at the first hearing on January 23 that "the financial world looks profoundly different than it did more than seven decades ago." As I stated earlier, it is profoundly different than even seven years ago. As the programs and operations of the Banks have continued to evolve with the financial institutions they serve, the need for greater financial and housing related expertise on the boards of directors has grown as well.

The Atlanta Bank recommends that the Finance Board adjust its regulations to permit an otherwise qualified person to place any stock or other financial interest in any member of a Federal Home Loan Bank into a blind trust for the purpose of meeting the statutory requirements of 12 U.S.C. 1427(a). Many of the most qualified individuals with the greatest financial expertise have experience in the financial services industry or have dealings with that industry. As a result, those persons most qualified to understand a Bank's business activities may have an interest in a financial institution that is a member of a Federal Home Loan Bank.

The quality and broad-based effectiveness of governance on the Banks' boards of directors could be enhanced by allowing a qualified person to place his or her prohibited financial interest into a blind trust, similar to the mechanism available to board members of other government sponsored enterprises, federal agency officials, and cabinet officials for specified terms of office. Given the short term of office (three years) applicable to a Federal Home Loan Bank director, as well as the nominal fee paid for service as a director, the requirement for divestiture of a prohibited financial interest may discourage otherwise qualified individuals from serving on the boards of the Banks.

Director Compensation –

Congress has already begun to consider changes regarding the compensation of Federal Home Loan Bank directors. The Financial Services Regulatory Relief Act of 2003 would eliminate the current limitations on board compensation that were enacted as part of the Gramm-Leach-Bliley Act. As the Finance Board has highlighted with these hearings, the responsibilities and obligations of a Federal Home Loan Bank director far exceed what they once were. Because the

Federal Home Loan Bank Act vests the management of each Bank in its board of directors, it is reasonable to consider whether the compensation for those directors should be flexible enough to be commensurate with that management responsibility and the time required of them to fulfill their governance obligations.

The Finance Board's own study of board governance reported that the limits have led to unintended consequences, such as reduced attendance at board meetings and reduced frequency of meetings.

Given the significant time requirement already imposed upon directors to attend board and committee meetings, and the low compensation directors receive, it is reasonable to ask how much additional time a director can contribute to FHLBank responsibilities. The Finance Board should determine – in addition to defining director qualifications – how much time (in days per month) should a director expect to spend on FHLBank duties. This will help build a rationale for any adjustments to compensation.

Director Terms –

One of the challenges that the Banks' managements and boards are faced with is the time required during board meetings to orient and educate newer directors. When the Banks' boards of directors meet, their agendas are generally extensive and time allotted to each issue is precious. To a large degree this is simply part of the business; however, to the extent that the operational design of the boards' appointive and election process can be modified to shorten or lessen the time required to regularly provide mini-orientations, greater energy can be devoted to pure governance.

The Financial Services Regulatory Relief Act of 2003, mentioned earlier and awaiting House floor action, contains another provision that may help in this regard. This provision would extend the terms of elected and appointed directors from three years to four years. Over the past several years there has been a natural turnover of directors. A large number of the directors of several Federal Home Loan Banks have less than two years' experience. Since 2002, 16 of the 18-member board of directors at the Atlanta Bank have been elected or appointed to their first term. That means we currently have only two directors with two years or more of tenure and experience on the board. As the Finance Board's study of board governance reported, "directors state that it takes six to 24 months to understand the operations of the Bank."   Longer terms could help bring greater continuity and experience to each Bank's board of directors.

Industry Director Elections –

Some have raised the issue of whether the current election process for industry directors should be reviewed. The current allocation of voting rights ensures that smaller members have a voice in the election of directors. Those that have raised questions about the current process suggest that the most active and, as a result, most knowledgeable Bank members, regardless of size, may be losing their voice in the process. Very active members tend to hold larger amounts of stock, and as a result may lose some of their voting rights to the average amount of stock required-to-be-held in their respective state calculation.

This is an issue that may be worthy of further discussion or review. However, the Atlanta Bank cautions that before any change is considered it is important to ensure that board balance is maintained and that no change inadvertently harms the Banks' cooperative structure.

Public Interest Director Appointments –

The appointment of public interest directors may be the single most significant manner in which the Finance Board affects the ability of the Banks' boards of director to engage in sound governance. Through the selection of the most interested and qualified candidates, the Finance Board can ensure that a sound knowledge base exits. Through the appointment of new directors, it can ensure that new and fresh ideas, as well as refreshed scrutiny, are brought to the table. And, through selective reappointments the Finance Board can help ensure that a degree of continuity and institutional knowledge is maintained.

The Atlanta Bank believes that each Bank, through its community and business relations, its board of directors, and its members should provide valuable guidance and recommendations to the Finance Board in their search for good, qualified and interested public interest directors.

There is no opportunity for this dialogue to take place currently, and we ask that you consider ways to facilitate it in the future.

Conclusion

Although we believe that the Federal Home Loan Banks' unique structure clearly dictates certain corporate governance rules that are different from those applicable to traditional corporations, we also believe that this unique structure does not minimize the need for strong corporate governance. To the contrary, the challenge and burden is greater than ever before on us at the Banks and you at the Finance Board to ensure that the governance in the Banks can be achieved at the highest standards.

In considering changes or enhancements to the Banks' governance practices, we urge you to bear foremost in your minds the maintenance of the Banks' mission and cooperative structure. As long as this effort seeks to design a governance model that fits the current structure of the Federal Home Loan Bank System, it will be valuable. However, if the System must be altered to fit into a different or "stock" governance model, then the community bankers who rely on the Federal Home Loan Banks to deliver needed financial services and credit to their communities may suffer, as will those communities they serve.

Mr. Chairman, you have said on many occasions that you, as our regulator, are not a cheerleader or advocate for the System. I could not agree with you more. As our regulator you are charged with ensuring that the Banks operate in a safe and sound manner. Part of that responsibility includes ensuring that the Banks are not prevented from operating in a manner that allows them to meet their corporate and public statutory missions. We appreciate your efforts to date, and I commit on behalf of the Atlanta Bank's board to continue to strive for the highest standards of corporate governance. As this process moves forward, the Atlanta Bank will continue to review the issues related to governance and would be pleased to provide further responses to any questions the Finance Board may have.

Thank you.