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FHFB CHAIRMAN CASTANEDA'S REMARKS AT THE ANNUAL CONVENTION OF AMERICA'S COMMUNITY BANKERS

The following are remarks prepared for delivery by Alicia R. Castaneda, Chairman of the Federal Housing Finance Board, at the annual convention and market expo of America's Community Bankers, held in Washington, D.C.

Hello everyone. Thank you, Bill, for that kind introduction. It is so nice to see so many of my friends with America's Community Bankers, and I do appreciate the invitation to address you today. You have certainly attracted many distinguished speakers for your conference, and I am honored to be included among them.

So, again, my sincere thanks.

Before I go any further, though, I must state that my comments today represent my views only, and I am not speaking on behalf of either the Federal Housing Finance Board or my fellow Finance Board colleagues.

Having been a banker for 28 years before joining the Finance Board, I do feel I'm with family and friends today, and what better group to celebrate an anniversary with?

Two anniversaries, really.

It's been 15 years since passage of FIRREA, the legislation that created the new Federal Housing Finance Board, made membership in the Federal Home Loan Banks voluntary, and allowed commercial banks to join the System.

It's also been five years since the passage of Gramm-Leach-Bliley, the landmark legislation that reshaped the world of financial services, including, of course, the Federal Home Loan Banks, and their regulator, the Federal Housing Finance Board.

So, I think this is a fitting opportunity to step back and take a look at where the Federal Home Loan Bank System is today, and to try to look ahead and see what's on the horizon.

Today also provides a good opportunity to look at where the Finance Board, too, stands as a safety and soundness regulator, one also charged with ensuring that the Banks fulfill their housing finance mission.

Confronted not only with the dramatic changes wrought by FIRREA and Gramm-Leach-Bliley, but also a continuing series of challenges in financial markets and the national and global economies, the Federal Home Loan Banks have managed to adapt to a rapidly changing world. Through it all, the System has remained safe and sound.

Some quick statistics, drawn from our Office of Supervision's most recent Profile of the Federal Home Loan Bank System, paint a big picture of a big System.

As of June 30 of this year, total assets of the 12 Federal Home Loan Banks were $902 billion. That represents an increase of 9 percent during the first half of 2004.

By comparison, at the end of 2000, total assets were about $675 billion. And, going back further, to 1990, assets were about $175 billion. So, taken in their entirety, the Banks have grown … and grown dramatically. San Francisco, the largest Bank, has some $160 billion in assets, while even the smallest tops $40 billion.

To put things in perspective, both the Dallas and Topeka Banks are the largest financial institutions by assets in their regions. Seven of the Banks are the second largest institution, and none of the Home Loan Banks ranks lower than fifth by assets, in their respective districts.

So, we are dealing with large financial institutions. And, although the Federal Home Loan Banks generally do not draw much public attention, they are critical institutions in our nation's system of housing finance.

Another way of measuring the System's value is by considering membership.

As of December 31st, 2000, membership totaled 7,777. While the composition of membership has changed a bit, largely through mergers and acquisitions, as of this June 30th, there were 8,083 members .

With so much attention being paid recently to mortgage programs – and I'll speak further about them in a moment – it is important, I think, to remember that the Federal Home Loan Banks continue to perform their mission of providing low-cost liquidity to their members primarily by making advances. Save for the Chicago and Seattle Banks, advances clearly remain the primary business of the Federal Home Loan Banks.

As of June 30th, advances represented 62.6 percent of the Bank System's assets, a slight percentage increase over the end of calendar year 2003.

Of course, from their inception in 1997 until this year, the mortgage acquisition – or Acquired Member Assets – programs of the Federal Home Loan Banks have grown rapidly. As of June 30th, total mortgage holdings were $115.6 billion, or 12.8% of System assets.

Taken together, advances and Acquired Member Assets account for over three-quarters of total assets.

Thus, the Banks appear to be fulfilling your needs as customers, and in doing so, fulfilling the housing finance mission that Congress chartered them to perform.

Still, I don't have to tell you that there are significant challenges ahead facing financial institutions in general, and the housing GSEs in particular.

The Banks – and their regulator – must remain fully up to the task of meeting them going forward.

For example, mortgages. We all know that American mortgages are among the most difficult-to-model financial instruments, due to embedded optionality that depends on their sensitivity to interest rates and the volatility of prepayments.

The growth of the Acquired Member Assets programs has certainly changed the risk profile, to varying degrees, at each of the Federal Home Loan Banks. So an ongoing challenge for the Federal Home Loan Banks is to properly measure and manage the interest rate risk exposure on their mortgage portfolios.

I will say the mortgage climate has changed this year, with mortgage originations slowing significantly. Consequently, during the first half of 2004, the Federal Home Loan Banks acquired some $15.9 billion in mortgages, down from $46.3 billion in the comparable period the year before.

I will ease off on all the statistics in a moment, but mortgage loans actually decreased as a percentage of total assets during the first half of 2004, from 13.7 to 12.8 percent Systemwide. And with the refinancing boom appearing to slow, interest rates forecast to rise, and other institutions appearing to have become more willing to hold mortgages themselves, significant near-term growth in these portfolios among the Federal Home Loan Banks seems unlikely.

Of course, the Federal Home Loan Banks operate in a regulatory and competitive environment that will continue to throw new challenges their way – much the same as you face in your own businesses.

Given this reality, while the System today is safe and sound, the Banks will continue to need strong and capable leadership and management – and a healthy dose of flexibility and adaptability – to successfully navigate the path forward in the best interests of the members and the public they serve.

They will also need, of course, the continued vigilance of their regulator. Indeed, a strong, prudent and vigilant regulator offers the Banks, their members, and the public the best means of protection.

At the Finance Board, we have been committed to ensuring the Banks have the capability to measure, monitor and control the risks they face, just as we have taken aggressive steps at the agency itself to carry out our oversight duties.

And our efforts will continue. Here are just a few highlights:

Last month my colleagues and I unanimously adopted a budget that will increase the size of our Supervision staff from 80 to 96 positions this fiscal year, including 40 examiner slots, two more positions to update our examination guidelines, two more accountants, and three additional analysts for our risk monitoring unit.

And because the Banks are all different – with different risk profiles – we have developed a team approach toward Bank supervision, much like that used by the other federal financial regulatory agencies.

In addition to our examiners, those teams include mortgage specialists, bank analysts, community development specialists, accountants and economists. Technology and systems are being upgraded to help them in their work. In short, we are developing teams of experts for each individual Bank, contributing to a rigorous program of oversight – one that simply didn't exists five years ago upon passage of Gramm-Leach-Bliley.

We have also placed new demands on the 12 Federal Home Loan Banks, verifying that they have the proper personnel, controls and technology in place to prudently monitor and manage the risks on and off their balance sheets.

An example of our increased supervisory attention is the guidance we issued a year ago August requiring each Bank to develop a capital management and retained earnings policy. Retained earnings are an important component of capital, and must be managed prudently.

Although Gramm-Leach-Bliley strengthened the Banks' capital base and created a class of capital stock subject to a five-year, rather than six-month, redemption period, retained earnings support dividends and serve as an important buffer protecting the par value of a Federal Home Loan Bank's stock against volatility and unexpected losses.

That is why the Finance Board takes the Federal Home Loan Banks' capital composition, including their retained earnings, very seriously. The point – and this point is sometimes missed – of our guidance to the Banks was not to demand a specific figure for retained earnings for all Banks, but to lead each Bank to undertake a very important exercise:

To look closely at its business plan, to consider the specific market, operations, accounting and other risks it faces, the needs of its members, expectations as to dividends – all of these things – and to develop a capital management and retained earnings policy supported by rigorous analysis, one that places a priority on maintaining a level of retained earnings. In short, to think things through.

We did not tell the Banks to ignore the unique features of their capital and structure, or the quality of the collateral they hold, or to stop paying dividends – to the contrary, capital structure, credit risk, interest rate risk, and dividend goals are things that should be considered in developing an appropriate policy at each Bank.

But they should be considered within a rigorous analytical framework, measured and quantified to the extent reasonably possible under a range of scenarios, both optimistic and pessimistic…just like any prudent financial institution of similar size and complexity would do as part of sound capital management.

We intend to continue paying close attention to retained earnings, and to work with the Banks where we have questions or concerns.

I should mention here one other development that has received little attention, even though it reflects a significant – and welcome – component of Gramm-Leach-Bliley, and that's the adoption of risk-based capital plans.

Prior to Gramm-Leach-Bliley, the Federal Home Loan Banks and their capital structures were unlike those of other financial institutions. They operated under a sort of a command and control regime, where the level of capital was set by statute, it did not correspond to risk, and the Finance Board limited the amount of risk an individual Bank could take on.

Gramm-Leach-Biley required the Banks to implement capital structures in which the required level of capital would reflect not just an institution's size or membership, but also the risks of its balance sheet and off-balance sheet activities. Under our current capital regulations, a Federal Home Loan Bank's risk-based capital requirements are based on measures of its credit, market and operations risk. In this way, the Federal Home Loan Banks' capital is more consistent with the requirements of the Basel Committee.

I'm pleased to say that nine of the Federal Home Loan Banks have implemented their plans. The remaining Banks are looking to do so by the middle of next year, and I know that the Finance Board is prepared to work with those Banks to assist where we can.

And all 12 Banks remain well capitalized, exceeding the minimum statutory leverage requirement of 4 percent.

Any discussion of the Banks -- where they stand, and where they're headed – obviously must touch on the issue of SEC registration.

I want to thank America's Community Bankers and the other trade associations for sponsoring last month's forum on the Federal Home Loan Banks. SEC registration represented a major part of the agenda, and I recognize that many of you are keenly interested in the issue.

I especially appreciated the willingness of Alan Beller of the SEC to address the gathering, which I hope helped to dispel some of the misconceptions out there regarding registration.

As many of you know, in June the Finance Board voted unanimously to require the Home Loan Banks to register with the SEC under the Securities Exchange Act of 1934.

All 12 Banks must publicly file a registration statement Form 10 with the SEC by June 30, 2005, and those registrations must be effective by no later than August 29, 2005.

In my visits to Capitol Hill, response to our registration rule has been uniformly positive. We did receive many questions, but I believe were able to answer them to people's satisfaction. It also appears that Congress will continue to pay close attention to corporate governance issues next session, and I simply do not believe there is any alternative to SEC registration.

As I said at last month's forum, there is no turning back.

Let me reiterate that the Finance Board, as the Banks' safety and soundness regulator, is actively doing its part, by working closely with the SEC to monitor the Banks' progress. And, although I believe all major issues have been dealt with, I am confident we would be able to address any new issue that might surface during the registration process.

We are requiring the Banks to keep us up to date on their plans and timelines to comply with the regulation.

And, drawing on the information we've obtained from the Banks and the SEC, the Finance Board will shortly be issuing additional guidance to the Banks addressing certain common questions about the process.

Now, again, the large, Systemwide issues raised by the Banks and others during the comment period were resolved to the Finance Board's satisfaction prior to our vote on the rule. We gave due consideration to the comments we received. And, we were – and are -- comfortable that any limited accommodations necessary to reflect the unique nature of the Federal Home Loan Bank System HAVE, in the case of the Finance Board, already been made and, in the case of the SEC, the intention to make them has been clearly and publicly stated.

And I would also like to say that I, for one, have been very pleased by the reasonable approach the SEC has taken toward the registration process. They have accommodated the System's unique structure and business model, with a great deal of flexibility and imagination.

Not only has the SEC made clear it is fully prepared to provide appropriate no-action and other relief to the Federal Home Loan Banks, but they have also offered to review draft Form 10s from each Bank prior to their public filing.

By reviewing the draft Form 10s – which should be submitted well in advance of the initial June 30 filing requirement date -- the SEC and the Finance Board will work with the Banks to identify and resolve issues unique to their respective institutions. I strongly urge the Banks to take advantage of this procedure as soon as possible.

But the time for purely hypothetical questions is past. It is time to actually submit draft forms. If there are any remaining Systemwide problems out there that need to be resolved prior to registration, they will only come to light if the Banks submit draft forms, with real numbers, to the SEC soon as part of the pre-filing, back-and-forth review process.

In fact, a number of Banks have already met with the SEC on a number of issues. I think, if you ask them, they have found the SEC accommodating and their time well-spent. If you, as members, have additional questions about the process, I would encourage you to talk with your Banks, see where they are, and hear what their plans are and what the SEC process has really been like.

But rest assured that the Finance Board will remain closely involved in this process. I anticipate continued meetings, communication and good, solid work both between the Finance Board and the SEC, as well as between the Finance Board and the Banks – both before and after registration.

Realizing how big of a step – a necessary step – SEC registration represents, we will keep in close communication with the Banks. And the Banks, I firmly believe, should do the same for their members. I am confident they will, and that the System will be the stronger for it.

Thank you all for allowing me this opportunity to join America's Community Bankers for this forum, and to mark the growth and change in the System and its regulator in the years since FIRREA and Gramm-Leach-Bliley.

Today I have tried to provide a big picture of a big System, one that serves your needs as members, and one that I believe successfully fulfills the housing finance mission given to it by Congress.

And in providing this big picture, perhaps it's proper to conclude with an even bigger one – that of the vital role of homeownership in our nation today.

The Federal Home Loan Banks and members of America's Community Bankers are doing so much, every day, to help families buy a home, to strengthen local communities, and, ultimately, to drive our nation's economy forward.

Our economy would simply not be as resilient without the great strides we have made in the number of people owning homes. There can be no doubt: Homeownership creates wealth. Last year, Americans took $139 billion out of the equity they had built in their homes – and that money went to finance their children's education, consumer goods, and new businesses.

And let me cite just a few more statistics that Secretary Alphonso Jackson – a member of the Federal Housing Finance Board -- is also fond of mentioning, because I think they show how important the work we all do is:

- The U.S. housing sector represents 14 percent of the nation's total GDP, embracing so many different sectors of the economy – builders, mortgage lenders, Realtors and bankers.
- For every 1,000 single-family homes built, 2,500 jobs are created, $75 million in wages earned, and $37 million in tax revenues generated.
- And today, a record number of Americans own their own homes – 69.2 percent. For the first time ever in history, minority homeownership has exceeded 50 percent.

We can always do better, of course, but these are still numbers which the nation should note, and in which the Federal Home Loan Banks – and the members of America's Community Bankers – can take pride – pride for your role in promoting home ownership in everything you do.

And just as the Federal Home Loan Banks fulfill their housing finance mission, you have my pledge, as Chairman of the Federal Housing Finance Board, that our agency will keep working diligently and professionally to ensure that the Banks remain safe and sound….and that their vital mission will continue to succeed.

Thank you again for this opportunity to join you today.

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