

Testimony of
Anthony P. Costa

On behalf of the

American Bankers Association

before the

Subcommittee on Oversight and Investigations

of the

Committee on Financial Services

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Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, my name is Anthony P. Costa, Chairman and co-CEO of Empire State Bank, a \$165 million bank headquartered in New York's Hudson Valley. I am glad to share my experiences regarding the Federal Home Loan Banks on behalf of the American Bankers Association, where I serve as Chairman of the ABA Federal Home Loan Bank Committee. ABA represents banks of all sizes and charters and is the voice of the nation's \$13 trillion banking industry and its two million employees.

The subject of today's hearing is timely. The Federal Home Loan Bank (FHLBank) System plays a vital role in providing mortgage finance and economic development to communities throughout the United States. The FHLBank System will undoubtedly be discussed in the context of work by Congress and the regulators to end the conservatorships of Fannie Mae and Freddie Mac, the Government Sponsored Enterprises (GSEs) that deal directly with secondary market housing finance. This discussion must focus on the FHLBank System's differences from those other two GSEs in purpose, structure and risk.

The FHLBank System is differentiated from the secondary market GSEs because of its history of financial stability, its higher statutory capital requirements, its mechanisms of joint and several liability among the 12 Federal Home Loan Banks and the cooperative capital structure of almost 8,000 members that is designed to protect taxpayers, and the plans recently approved by the Federal Housing Finance Agency to increase capitalization levels significantly above levels required by statute. As lawmakers consider changes affecting Fannie Mae and Freddie Mac, it is important to remember that any reform is likely to have an impact on the Federal Home Loan Banks. Great care must be taken with any reform of the secondary mortgage market to protect the traditional business of the FHLBanks and access to liquidity by their members. Failure to do so will have a detrimental effect on mortgage funding and home ownership for many years to come.

The FHLBanks are 12 regional cooperative banks created by Congress that provide banks with access to funding for community lending. The FHLBank System has been in place for eight decades, weathering the toughest economic storms, including the recent financial crisis. Banks like mine purchase stock in our regional FHLBank and become a member/owner. Because the FHLBanks are cooperatives and the stock is not publicly traded, there is no pressure for high rates of return or the risky business activities that accompany that strategy. Rather, as cooperatives, FHLBanks provide valuable liquidity to banks like mine so that we can make loans and fund the operations of the bank at a cost that is reasonable.

The importance of the role our FHLBank plays in our business plan cannot be overstated. Although it is not the only place we go to meet our liquidity needs, it is one of our primary sources. I can connect the funding of many individual loans directly back to FHLBank liquidity and funding. Many of our loans would not have been made were it not for our FHLBank.

There are three points I would like to make today that I hope will help illustrate the important role that the FHLBank System plays for banks across the country and demonstrate how critical it is that any reform of the mortgage finance system does no harm to the FHLBank System:

- **The Federal Home Loan Banks are essential to enable community banks to meet the needs of their communities.** Without the FHLBanks, community banks would not be able to reliably meet loan demand.
- **The FHLBanks performed exactly as intended during the financial crisis.** The FHLBanks continued to provide liquidity even as the credit markets largely froze up. This was a challenge, but they continued to meet their mission, because of the flexibility of the structure and membership in the system.
- **The FHLBanks' Programs provide assistance for the development and operation of affordable housing developments and collaborations.** The Affordable Housing Program and Community Investment Program help to fund lending that would otherwise be impossible.

I. The Federal Home Loan Banks Are Essential to Enable Community Banks to Meet the Needs of Their Communities

The central business of the FHLBanks is providing liquidity and funding to member banks in the form of advances, which are essentially loans that are in turn used to fund community development. To qualify for advances, banks members pledge high-quality collateral, in the form of mortgages, government securities, or loans on small business, agriculture or community development. Banks also purchase additional stock in proportion to their borrowing.

Banks can use funding from advances to facilitate lending in their communities. Let me give you an example. Loan growth often outpaced our ability to grow our deposit balances. Short-term FHLBank advances enable us to fill this gap and fund those loans. Moreover, longer-term fixed-rate advances allow us to better match funding and loan maturities. This is particularly useful in helping community banks manage interest rate risk. The FHLBanks allow banks to fund longer-term projects that might be impossible with only deposits, particularly in this low interest rate environment. By being able to more closely match Federal Home Loan Bank advances with various projects' average loan lines we do projects in the community that would not otherwise be possible with deposit funding.

Another source of liquidity for home mortgages available through the Federal Home Loan Banks is the Mortgage Partnership Finance Program (MPF). Through the MPF, mortgage risks are shared through a partnership that combines the retail credit expertise of a local mortgage lender with the wholesale funding advantages of an FHLBank. A variety of products ensures that mortgage lenders of all types and sizes can gain access to the secondary market. Empire utilizes the MPF to provide liquidity by selling qualifying residential mortgages into the program. We receive a competitive price on the mortgages as well as ongoing fee income for retaining a portion of the credit risk on the loans. ***Access to a market of this kind would be all but impossible without a vibrant FHLBank System.***

In addition to liquidity management through advances and the MPF, the FHLBank System also provides letters of credit for municipal bond issuances guaranteed by member banks. Through letters of credit, the FHLBanks pass through their high-quality credit rating to member institutions, while pledging to be a credit backstop. Larger FHLBank members can carry out large projects that use bond financing. The FHLBank provides a credit enhancement to the

bank's letter of credit on bonds, thereby assisting in lowering interest rates for municipal project financing.

Recently, there have been regulatory proposals to modify bank membership requirements and to limit the level of advances available to larger members. These changes would make it more difficult for all financial institutions to access the liquidity available through FHLBank advances, devaluing membership for existing FHLBank members, and discouraging potential members from joining. Having liquidity and competitive funding available in the FHLBank System depends upon sufficient volume. An FHLBank System made up exclusively of small members could not achieve this volume and efficiency. Likewise, even larger members cannot always get the kind of pricing available through the Home Loan Banks on their own. Simply put, such proposals would impair the ability of FHLBanks to support housing and economic development in communities across the nation.

These changes that would fundamentally alter the services that FHLBank members use to meet their community and borrower needs should not go forward. Banks like mine simply could not provide the same level of products and services to our communities without the Federal Home Loan Bank. And the Federal Home Loan Banks could not offer us the funding levels and the pricing it does without the involvement of all sizes of institutions. The FHLBank System is a true cooperative.

II. The FHLBanks Performed Exactly as Intended During the Financial Crisis

During the recent financial crisis, the FHLBanks played a critical role for bank members. As the crisis took hold and interbank lending froze, the FHLBanks were the first available source of funding for U.S. financial institutions, preventing far greater losses and potential institutional failures. As members had more need for liquidity, FHLBanks increased the availability of advances from about \$650 billion at the beginning of the crisis to over \$1 trillion in the peak of the crisis. That demand for liquidity receded and advances are now below pre-crisis levels. This proves the flexibility of the system and demonstrates its ability to withstand crises.

In eight decades and through several financial crises, the FHLBanks have never incurred a credit loss on an advance. This remarkable record can be attributed to the collateralization of all advances, conservative underwriting standards and strong credit

monitoring policies. Simply put, the FHLBanks met the needs of banks like mine at the time it was most required, allowing us to continue to serve our communities, even in the face of extreme difficulties.

The FHLBank System performs so well because it is structured in a way that supports flexibility. A recent Administration proposal would change that structure. A February 2011 report to Congress on reforming the housing finance system included as a potential reform for the FHLBanks to restrict each financial institution to membership in only a single FHLBank. Current law permits, with certain limitations, that an institution can be a member of more than one FHLBank. This most commonly occurs where institutions are members of adjacent districts because their businesses cross district lines, and where multi-bank holding companies maintain separate charters that focus on business in separate geographies.

The current format provides two substantial benefits to the strength of the System. First, it spreads out the advances business. Fostering a diversification of advances income is integral to the regional structure of the System. Forcing larger members to choose a single FHLBank could destabilize the System by concentrating business in a few districts and hurting access to advances in other parts of the country. Second, aligning FHLBank membership by charter location effectively diversifies risk by enabling different discrete management teams to each handle a share of the business. This diversification promotes safety and soundness, as multiple management teams are unlikely to pursue and implement the same strategies. The Administration's proposal would concentrate business, create disincentives for some lenders to maintain System membership, and create arbitrary funding deadlines – damaging changes for a cooperative that is functioning just as it was intended to, particularly in the face of economic challenges.

III. The FHLBanks' Programs Provide Assistance for the Development and Operation of Affordable Housing Developments and Collaborations

The FHLBank System, through a dependable structure and prudent financial management, is able to do even more than liquidity management. The FHLBank System also runs two important programs that provide housing and economic development for low- and moderate-income communities: the Affordable Housing Program (AHP) and the Community Investment Program (CIP).

The AHP is one of the largest private sources of grant funds for affordable housing in the United States. It is funded with 10 percent of the FHLBanks' net income each year. The AHP allows for funds to be used in combination with other programs and funding sources, like the Low-Income Housing Tax Credit. These projects serve a wide range of neighborhood needs: many are designed for seniors, the disabled, homeless families, first-time homeowners and others with limited resources. More than 726,000 housing units have been built using AHP funds, including 457,000 units for very low-income residents and the FHLBank System is the largest single funding provider to Habitat for Humanity. The total AHP contribution since 1990 is over \$4.3 billion. Through the AHP, banks can fund programs that otherwise might never be carried out.

The CIP offers below-market-rate loans to banks like mine for long-term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods. The program is designed to be a catalyst for economic development because it supports projects that create and preserve jobs and help build infrastructure to support growth. Banks like mine have used CIP to fund owner-occupied and rental housing, construct roads, bridges, retail stores, sewage treatment plants and provide small business loans. The program is especially appreciated in rural areas where resources are limited. Since 1990, CIP has lent over \$61 billion for a variety of projects, resulting in an estimated 200,000 jobs.

ABA believes that the changes proposed by the Administration and the regulators would have a deeply negative impact on the ability of FHLBanks to carry out these important programs. The FHLB System is strong because of the diversity of its membership. Changes to the membership rules and structure would damage the reciprocal relationship between each member, each cooperative, and the FHLBank System as a whole.

As an example, some holding companies choose to maintain separate charters for their subsidiaries in order to create closer ties with that institution's community and to maintain a local presence. One way that these institutions do so is through the AHP of their regional FHLBank. Limiting a holding company to a single FHLBank membership, as proposed by the Administration's plan, would effectively limit some members' participation in AHP in their district. This limitation would have the effect of concentrating AHP funds in some districts at the expense of others, arbitrarily punishing some members and communities while rewarding others.

Conclusion

The Federal Home Loan Bank system is not only critical to the day-to-day functioning of many community banks across the country, but plays a pivotal role in providing funding to improve low- and moderate-income communities. Proposals to improve the overall housing finance situation – through changes to Fannie Mae and Freddie Mac, and GSEs as a whole – should not make modifications to the FHLBank System. The FHLBanks have a track record of success even in the face of extreme financial challenges.