Statement of

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Mr. Chairman, Ranking Member Frank, and Members of the Committee, I appreciate the opportunity to speak to you today about the Federal Home Loan Banks (FHLBanks) and legislative proposals to reform regulation of the housing government sponsored enterprises. My name is David Hehman and I am President and CEO of the Federal Home Loan Bank of Cincinnati (Cincinnati FHLBank).

I would like to provide an overview of the FHLBanks, address the impact of recent legislation and conclude with the topic of regulatory reform.

FHLBank Overview

The FHLBanks were created in 1932 to support America's housing finance system. It was largely the FHLBanks' ability to raise long term debt in the capital markets and pass that funding along to their member financial institutions that encouraged the development of the 30 year fixed-rate mortgage that is the predominant financing tool in the United States mortgage finance system today.

The FHLBanks continue to play a vital role in the nation's housing finance and community lending system. Member institutions, primarily community banks and thrifts, use the FHLBanks' advance programs to meet the mortgage and community lending needs of their local markets, and use our Affordable Housing Programs to help house thousands of low-income families in those communities.

The FHLBank System (System) is comprised of 12 regional FHLBanks, their 8,080 member financial institutions and the Office of Finance that issues debt on behalf of the 12 regional FHLBanks. The regional FHLBanks are overseen by an independent regulator, the Federal Housing Finance Board (Finance Board).

The System is a unique GSE. While the System shares a congressional charter and housing mission with Fannie Mae and Freddie Mac, the FHLBanks are fundamentally different in both structure and perspective. The 12 regional FHLBanks and their members form a cooperative that is driven by customer credit demand, not profit maximization. And while the 12

FHLBanks are independently owned and operated, they share joint and several liability for the System's debt. This leads to very conservatively run operations that have been effectively supervised under the current independent regulatory regime designed by Congress.

Legislation

Congress has historically taken an active role in defining the mission and structure of the System. Two critical pieces of legislation shaped today's FHLBanks. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) expanded membership to include commercial banks and credit unions with a demonstrated commitment to housing finance. FIRREA also created the System's Resolution Funding Corporation assessment and mandated the Affordable Housing Program through which each FHLBank sets aside 10 percent of net earnings annually for the creation of affordable housing throughout the nation. That commitment has resulted in $1.7 billion of private capital flowing into the housing market to create 380,000 units of affordable housing.

Title six of the Gramm-Leach-Bliley Act of 1999, sponsored by Congressmen Baker and Kanjorski, established universal voluntary membership; provided for a permanent capital structure; expanded the types of collateral that community institutions can pledge to secure advances, and increased the independent corporate governance of each FHLBank.

Six FHLBanks, including Cincinnati, have implemented newly required capital stock plans. This monumental task has occurred well within the legislative time frame, and is due in no small part to the strength of the System's independent regulator and the commitment of the boards of directors at each FHLBank. The new capital structures have left the System with $38 billion of capital with an aggregate capital-to-assets ratio of 4.7 percent as of June 30, 2003.

Financial Profile

These two pieces of legislation combined with the performance of the FHLBanks in the marketplace and customer demand for FHLBank products, resulted in considerable growth over the last decade. As of June 30, 2003, the FHLBanks had combined total assets of $809 billion up from $721 billion a year ago, and up from $166 billion a decade ago. Likewise, FHLBank membership saw a dramatic increase from 3,900 members at June 30, 1993 to just over 8,000 at June 30, 2003.

A financial snapshot of the Cincinnati FHLBank is also instructive to understanding how and why the cooperative structure is successful. The Cincinnati FHLBank is comprised of 750 members serving Ohio, Kentucky and Tennessee. As of June 30, 2003, Cincinnati reported $47 billion in advances, $7 billion in acquired mortgage assets (AMA) and $144 million in Affordable Housing Program grants invested into the creation of 25,000 units of housing. These are not just numbers. These are telecommunications jobs in Urbana, Ohio; the 1000th Habitat House in Kentucky dedicated last weekend; a small home-improvement loan program in Memphis that combats predatory lending; and 25 community based financial institutions that were able to sell mortgages in the secondary market for the first time.

My job as president of the Cincinnati FHLBank and the job of my Board are to ensure the success of this cooperative partnership. That is how we fulfill our housing finance mission. Our role of linking Main Street to Wall Street demands the flexibility to access the capital markets that we now enjoy. The Cincinnati FHLBank stands ready to fund the housing, economic development and liquidity needs of our members on a continuous basis. Cincinnati FHLBank advances are a critical component of the asset/liability management of our community based institutions as evidenced by the fact that approximately three of every four members have borrowings outstanding at any given time. This flow of funds from Wall Street to Main Street is clearly demonstrated by the financing activity of our FHLBank this past month. The Cincinnati FHLBank participated in 71 separate issues of fixed rate debt ranging in maturity from one to 15 years. The average size of the bonds issued was $34 million, a very small number by bond market standards. The funding raised was used to directly support member advance demand and mortgage note sales as well as provide the Cincinnati FHLBank with its pool of liquidity.

Independent Regulator

My Board and I believe that we can best support and build upon our successful record with a strong, independent regulator, engaged corporate governance, and effective risk management. Under our current regulatory regime, the Finance Board's primary duty is "to ensure that the FHLBanks operate in a financially safe and sound manner." The Finance Board is not limited by funding constraints in carrying out its declared focus of ensuring the FHLBanks' safety and soundness. Its funding is provided by assessments on the FHLBanks that are not subject to review or challenge by the FHLBanks.

Finance Board regulations govern a broad range of FHLBanks' operations including advances pricing, risk management, capital plan approval, directors' responsibilities and new business activities. The Finance Board also collects and monitors financial and risk management data from the FHLBanks each month, performs ongoing reviews of all aspects of the FHLBanks' operations and conducts annual on-site examinations of all 12 FHLBanks. The Finance Board's 2004 budget would include a $4.3 million increase devoted to the supervision function. The FHLBanks all believe that it is essential to have a strong, independent regulator with the resources to ensure the FHLBanks' continued safety and soundness as well as to oversee the housing mission.

Corporate Governance

Finance Board regulations require that the FHLBanks' boards of directors fulfill the typical corporate director duties including, but not limited to, the responsibility to select and oversee management, the responsibility to ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, and a member products policy that details the Bank's credit and pricing policies, and the responsibility to approve the FHLBanks' annual operating and capital budgets and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. Finance Board regulations require each FHLBank's board of directors to have an audit committee with very specific regulatory responsibilities, including direct oversight of the FHLBank's internal and external audit functions. The boards of directors also typically establish other committees to facilitate their oversight of management. Committees vary from FHLBank to FHLBank, but typically include risk management, human resources and housing oversight functions. The various elements of the FHLBanks' corporate governance structure combine to provide boards of directors that are active, knowledgeable, and engaged, and that are fully aware of their responsibilities and take them very seriously. The Finance Board recently completed a Systemwide study of corporate governance across all 12 FHLBanks. The results and recommendations of this study were presented to our Board for review and approval this past summer.

Risk Management

As 12 independent institutions, each of the FHLBanks is responsible for its own risk management activities. Each FHLBank has its own risk profile guided by a number of factors that are held in common across the FHLBanks. This approach enables each FHLBank individually, as well as the Consolidated Obligations (COs) issued by the 12 FHLBanks collectively in the capital markets, to be rated AAA.

The cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk profile in search of higher returns. In my opinion, this cooperative structure discourages FHLBanks from taking excess risk. The mission of the cooperative is to provide member institutions the funding and financial services they need to meet the credit needs of their underserved communities. At the same time, the FHLBank must generate an adequate return for member shareholders that meets their opportunity cost of investing capital in a AAA-rated cooperative enterprise. Rates of return on FHLBank stock will average in the neighborhood of four percent in 2003, far below the rate of return expected from publicly traded corporations.

FHLBanks are required by regulation to maintain a Risk Management Policy, reviewed at least annually and a Financial Management Policy, which governs permissible investment and derivative activities and overall risk management limitations. FHLBanks are subject to very conservative capital requirements with total capital equal to at least 4.0 percent of total assets and must have sufficient permanent capital to meet a risk-based capital requirement established by the Finance Board. The FHLBanks minimize credit risk by ensuring that advances are fully secured, that their investments are limited to issuers or securities that are highly rated at the time the investments are made, and that their AMAs have appropriate risk-sharing features. No FHLBank has ever suffered a credit loss on an advance to a member in the FHLBanks' 71-year history. As of June 30, 98 percent of the FHLBanks' investment securities have long term ratings of AAA or the corresponding highest short term ratings. In addition, due to the risk sharing structure of the AMA programs, the FHLBanks' loss experience on AMA assets has been virtually nonexistent. Exposure to market risk is controlled by the Financial Management Policy's conservative limits. The incentive to maintain the conservative limits arises through the cooperative, non-publicly-traded-stock structure of the FHLBank.

Because history is not always an accurate predictor of future performance, each FHLBank uses sophisticated, high quality financial models to continually assess the magnitude of the risk to each FHLBank's estimated market value of equity and earnings from various changes in interest rates, mortgage prepayment speeds and other market variables. These models are provided primarily by market-tested third-party companies with expertise in measuring market risk of mortgage instruments, advances, corporate debt and derivatives. The FHLBanks monitor and manage market risk continuously throughout every month. The market risk position is reported and discussed with each FHLBanks' boards of directors at each board meeting. The integrity of the process is ensured through close board oversight, annual Finance Board examinations, internal and external audits, and separation of personnel responsibilities. Personnel responsible for assessing market risk are separate from personnel responsible for day-to-day risk management activities and are further separated from personnel preparing FHLBank monthly financial statements.

Legislative Reform of GSEs

The combination of congressionally determined financial requirements, an independent regulator, engaged boards of directors and extensive risk management tools have proven to be a successful model. However, adherence to this model is not mutually exclusive to aversion to change. The Cincinnati FHLBank wants to do what is best for the financial quality of our institution and, by extension, for the public it serves.

At its regularly scheduled meeting last month, the Cincinnati FHLBank Board of Directors concluded that it is in the best interest of its shareholders and the public they serve to retain the present independent regulatory structure for the FHLBanks. The structure and performance of the Finance Board has resulted in 12 healthy, AAA-rated regional FHLBanks that currently support $500 billion worth of credit activity, serving virtually every neighborhood in America.

The Finance Board's independence alleviates political and department-specific affiliations that may bias its oversight function. The current post-FIRREA Finance Board has presided over the most expansive and prosperous period of FHLBank history against a backdrop of extreme volatility in the market place. During this time, each FHLBank has maintained a AAA rating and continued the 71-year tradition of never having experienced a loan loss. The current Finance Board Chairman has more than doubled supervisory staff to 17 examiners and has budgeted for a total of 30. Further, the structure of the Finance Board allows for safety and soundness as well as mission oversight of the $1.7 billion Affordable Housing Program and multi-million dollar community investment programs to fall under one regulatory roof. This independent, comprehensive regulatory structure tailored for the System works, and works well.

At the same time the Cincinnati FHLBank Board of Directors affirmed its support of our independent regulator, it also directed management to begin immediately the process of registering its stock under Section 12 of the Securities and Exchange Act of 1934. This statement of direction came after preliminary meetings with SEC officials to discuss issues arising from the unique nature of the FHLBanks and the equity shares held by its members. The Cincinnati FHLBank strongly believes that registration of stock with the SEC is the best method to provide both bond and stock investors the necessary financial information they require to assess the condition of our FHLBank.

Some critics of the current regulatory structure have argued that the FHLBanks will be disadvantaged in their funding decisions if their regulator operates outside of the Treasury Department. While we appreciate that position, we do not share it. In fact, at the present time the debt issued by the FHLBanks trades at a premium relative to other GSEs. We are confident the financial markets will continue to recognize that the FHLBank System consists of financially sound and conservatively managed, well capitalized institutions whose primary goal is to serve its housing finance mission through its members. This current position will be further strengthened with SEC registration.

Conclusion

The FHLBanks are strong, conservatively run enterprises without a single credit loss in their 71-year history. There is no problem in need of a solution. The System's current independent regulator is best positioned to provide both safety and soundness as well as mission oversight for our cooperative enterprise.

Mr. Chairman, thank you for the opportunity to address the Committee on this important matter. I will be happy to answer questions at the appropriate time.