



Testimony of

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On behalf of the
Independent Community Bankers of America

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Introduction

Chairman Frank, Ranking Member Bachus, thank you for this opportunity to present the views of our nation's community bankers on the future of housing finance. My name is Jack Hopkins and I am President and CEO of CorTrust Bank in Sioux Falls, South Dakota. CorTrust is a national bank with more than \$600 million in assets. CorTrust Bank is a Seller/Service for both Fannie Mae and Freddie Mac, and currently services more than 3,500 loans with balances exceeding \$400 million. I am proud to testify today on behalf of the Independent Community Bankers of America¹ and its nearly 5,000 community bank members nationwide.

Community Banks Rely on GSEs

ICBA has been a strong supporter of Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks), and community banks across the nation have benefited greatly by the liquidity they provide and by the robust secondary mortgage market they have created which over the years has enabled community banks to offer mortgage products to their customers and invest in mortgage-backed securities.

In 2008 and 2009, CorTrust Bank originated more than \$150 million and \$250 million in secondary mortgage loans respectively. We have also used FHLBank advances extensively over the last few years to fund fixed-rate commercial and agricultural loans, as well as provide liquidity for the bank. We currently have \$34 million outstanding to support our lending. We have also purchased the GSE bonds over the years to support our investment portfolio and liquidity requirements, as well as to fulfill pledging requirements for municipal deposits.

These GSEs have made it possible to combine wholesale funding and community bank service at the local level.

Though very different in key respects, all three housing GSEs provide community banks with irreplaceable access to money markets. This access allows our members to offer the same home mortgage products to our customers that the largest firms offer to theirs. Without the GSEs, community banks would be unable to offer their customers long-term fixed rate mortgages. In addition, the FHLBanks provide members advances for liquidity, asset/liability management, and to fund long term loans to small

¹ *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than \$1 trillion in assets, \$800 billion in deposits, and more than \$700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

businesses and other customers. It is critically important that the GSEs remain reliable sources of funding and liquidity and continue to support a residential mortgage secondary market for our nation's community banks.

ICBA commends this committee for taking on the difficult and complicated task of rebuilding America's housing finance system and resolving the conservatorship status of Fannie Mae and Freddie Mac.

While there has been a great deal of discussion about what caused the financial crisis and the roles the GSEs may have played in it, today I would like to focus on the future of housing finance in this country.

Future of the GSEs

Since the government placed Fannie Mae and Freddie Mac under conservatorship in late 2008, the Treasury Department has committed to purchase more than \$125 billion in preferred stock of the GSEs, and government agencies bought more than \$1.3 trillion in mortgage-backed securities. In December, 2009, the administration lifted its \$400 billion cap on assistance to the two GSEs saying it would cover unlimited losses through 2012. While these actions clearly helped maintain the flow of housing credit and prevented the complete collapse of our nation's housing markets, it is equally clear that this is not a long-term solution.

GSE Preferred Shareholders Must Be Made Whole

An unfortunate by-product of the government's take-over of Fannie and Freddie is that the value of GSE preferred shares plummeted, injuring more than a thousand community banks that purchased these shares with the encouragement of their regulators. Banks are generally prohibited from investing in the stock of other corporations, making AAA-rated GSE preferred shares an attractive option, and one that Treasury and the regulators promoted.

The actions of then-Treasury Secretary Paulson, primarily to protect the interests of the Chinese government (his own admission in Paulson's book [On the Brink](#)), resulted in an "ambush" of preferred shareholders by placing the preferred shares in a second position and eliminating all dividend payments. Despite earlier warnings by ICBA, Paulson's actions sent the entire market for financial preferred shares into a freefall, making it even more difficult for community banks to raise needed capital when additional capital was desperately needed.

Notably, nearly \$36 billion in Fannie and Freddie preferred stock was outstanding prior to Fannie and Freddie being placed into conservatorship. An estimated \$15 to \$20 billion of that was held by the banking sector and almost one-third of banks reported holdings including many community banks. In my opinion, this action has directly

resulted in the failure of many banks by wiping out any excess capital that may have been available prior to normal losses experienced in a recession, such as we are now experiencing. These actions continue to have detrimental consequences on many community banks today by driving down capital levels and reducing the amount of available credit.

As this committee deliberates over the future of housing finance, ICBA urges you to ensure that this injustice is corrected by restoring the dividend payments on Fannie and Freddie preferred shares and paying injured holders the amount of suspended dividends from September 7, 2008, on an estimated \$20 billion in GSE preferred holdings. As options are being considered to lift Fannie and Freddie out of conservatorship, ICBA urges that it be done in a way that will restore a reasonable value to the preferred shares. Helping restore the \$15 to \$20 billion in community bank capital value crushed by the unwarranted Treasury actions can foster \$150 to \$200 billion in new lending as banks leverage this capital.

ICBA would like to thank Chairman Frank and other members of the committee for their efforts on behalf of community banks to correct this injustice.

Range of Proposals

A number of proposals have surfaced recently to reform the GSEs, ranging from abolishing Fannie and Freddie and allowing the private securitization market to take over, to restoring Fannie and Freddie to their former selves. Other ideas include creating a covered bond market that would allow banks to issue mortgage-backed debt to finance mortgage loans, or allow each of the twelve Federal Home Loan Banks to securitize loans. The Mortgage Bankers Association favors a plan that would allow banks to charter their own GSE units with the government providing a guarantee for the securities.

Corporate Structure, Governance and Mission

As Congress considers these proposals, you will be faced with critical questions relating to corporate structure, governance, and mission. These are crucial issues that will require careful study as the solutions will have long-term effects.

What should the corporate structure of the secondary market be? Of the structures currently under debate, the cooperative structure or that of a public utility appears to be the most suitable for the needs of community banks. The cooperative structure has served the Federal Home Loan Banks well as its users also provide capitalization that is at risk. If the secondary market is capitalized by private, non-user capital, the private utility structure may be appropriate to set pricing and control undue risk taking.

What should be the ownership structure of the secondary market? Should the users be the owners such as in the FHLBank and Farm Credit systems? Should they provide all of the capital or should there be outside shareholders?

What should the governance structure be? Should users elect directors (some users, some outside independent directors)? Should there be presidentially appointed directors?

What should the mission be? The primary mission of Fannie Mae and Freddie Mac is to provide stability to the secondary market for residential mortgages, access to mortgage credit throughout the nation, to increase the liquidity of mortgage investments and to improve the distribution of investment capital for residential mortgage financing. Should this be changed? Are there other functions the secondary market entities could take on to help community banks and their customers?

Key Principles

ICBA is in the process of studying these proposals and considering these questions. What is clear is that community banks need a secondary market for residential mortgages. Without a reliable secondary market for residential mortgage loans, many community banks would be unable to offer this service to their customers. As the Administration and Congress consider how to resolve the conservatorship of Fannie Mae and Freddie Mac, and re-build America's housing finance system, ICBA has developed the following key principles that we believe must be included in the future structure of the secondary market for residential mortgages.

- *The secondary market for residential mortgages must be impartial.* The secondary market must provide equitable access and pricing to all lenders regardless of size or volume. Lenders large and small need secondary market access and consumers benefit by their activity in the mortgage market.
- *The secondary market must be financially strong and reliable.* Recent legislation established a world class regulator for Fannie Mae and Freddie Mac; strong regulatory oversight must be maintained to ensure that the secondary market operates within its mission and in a safe and sound manner.
- *The secondary market entities must have a limited mission focused on supporting residential and multifamily housing in all communities in the U.S.* Resources should be focused on supporting housing finance. Fannie Mae and Freddie Mac created uniformity to the market through the underwriting and processing systems they developed. The secondary market entities should continue their technical innovations that can be shared with their users to the ultimate benefit on consumers

- *The secondary market entities need to have the operational flexibility to hold some mortgages in portfolio when market conditions dictate, along with their securitization authorities.* Recent market events demonstrate the important role Fannie Mae and Freddie Mac have played in providing liquidity and market stability when other sectors of the market cease to function. Portfolio levels can be controlled through regulations and regulatory oversight.
- *The conflicting requirements of a public mission with private ownership must be eliminated.* Fannie Mae and Freddie Mac had housing goals for the purchase of mortgages from underserved people and in underserved areas. Meeting the demands of maximizing shareholder wealth created an environment where the two GSEs took on inordinate amounts of risk. This conflict must be eliminated going forward.
- *Congress should consider requiring the secondary market entities to dedicate a portion of their earnings to support housing programs in a form such as the Federal Home Loan Bank Affordable Housing Programs in return for the benefits of GSE status and in the place of the current housing goals.* The Federal Home Loan Bank Affordable Housing Program has been a very successful vehicle to help support affordable housing in a very structured, regulated manner. Dedicating a percentage of income to such a program would provide a return benefit to the public for the benefits of GSE status.
- *The accumulation of retained earnings must be an important component of the secondary market structure to provide some level of initial protection of user or private capital.* Many community banks were encouraged by regulators to purchase preferred stock in Fannie Mae and Freddie Mac and lost essentially all of their investment. Retained earnings will help to attract needed equity capitalization going forward.
- *Congress must ensure that a secondary market with government ties continues to exist.* Whether the Fannie Mae and Freddie Mac charters are retained or a new secondary market is created, it must have some government tie going forward to ensure continued steady and favorable access to the capital markets.
- *More than one secondary market entity should exist in the future.* The existence of more than one secondary market entity fosters competition, providing better access for community banks and lowers mortgage rates and closing costs for consumers.
- *The function of Fannie Mae and Freddie Mac should not be incorporated into the FHLB system.* There has been a suggestion that Fannie Mae and Freddie Mac be split up and incorporated into the Federal Home Loan Bank system. While the

Federal Home Loan Banks have had a limited secondary market function, the focus of their business must remain that of providing liquidity to their members to support housing, economic development, small farm, small agribusiness and small business lending.

Importance of the FHLBanks

The Federal Home Loan Banks must remain a strong, stable, reliable source of funding for community banks. As the financial crisis has moved through the financial system, many of the FHLBanks have suffered financial stress too, as mark-to-market accounting forced them to write down the value of securities, and debt issuance spreads widened increasing the cost of funds to members. Yet, throughout the financial crisis, the FHLBanks continued to provide advances to their members without disruptions, while other segments of the capital markets ceased to function. Daily, community banks depend on their FHLBanks for liquidity, asset/liability management and to enable them to match fund longer term loans. We must ensure a healthy, stable, vibrant FHLBank system that is a reliable source of funding, liquidity and other products to serve the needs of all its member/owners and provide lendable funds for the local communities they serve.

The FHLBanks have been repaying their REFCORP obligations more quickly than expected due to strong earnings. This rapid payoff has caught the attention of some who look at the FHLBanks as a potential source of funds for other purposes. There are already suggestions that the FHLBanks should continue to make the payments once the obligations are completely paid for. Once the FHLBanks complete their REFCORP payments, the earnings that would otherwise go to them should be kept in the FHLBank system to build retained earnings and protect the system's financial condition. Once the system has built sufficient safeguards to protect it against future financial challenges, funds may be used within the system for programs that help members serve their communities. The FHLBanks, their members and the consumers and businesses they serve across the country should not be penalized because the FHLBanks paid off their debts early.

ICBA continues to study the role the FHLBanks should play in facilitating a secondary market for residential mortgages. In a 2009 report, the Congressional Research Service suggested that Fannie Mae's and Freddie Mac's mortgage portfolios and other assets be divided among the FHLBanks. ICBA does not believe this is there right solution to the resolution of the two housing GSEs. Further, we would have significant concerns about any proposal to incorporate the function of Fannie Mae and Freddie Mac into the FHLBank system. While community banks have benefitted from the existing FHLBank secondary market programs, the primary business of the FHLBanks must remain advances.

Conclusion

Community banks rely on Fannie Mae and Freddie Mac to provide a reliable secondary market for residential mortgage loans they offer to their customers. Community banks rely on the Federal Home Bank System to provide liquidity, asset/liability management and long-term funding. Access to these GSEs is vital to the ability of community banks to provide financing options for housing, small businesses and agriculture.

Whatever solution Congress ultimately chooses to resolve Fannie and Freddie's conservatorship issues and restructure the future of housing finance, it must provide equitable access and pricing to all lenders regardless of size or volume.

Thank you for this opportunity to present the views of our nation's community bankers.