FEDERAL HOUSING FINANCE BOARD

PUBLIC HEARING
ON BOARD GOVERNANCE OF THE
FEDERAL HOME LOAN BANKS

Tuesday, February 10, 2004
Washington, D.C.

The Hearing convened, pursuant to notice, at 10:00 a.m., at 1777 F Street, N.W., Second Floor Board Room, Washington, D.C.

MEMBERS PRESENT:

JOHN T. KORSMO, Chairman

JOHN C. WEICHER, Director

ALLAN I. MENDELOWITZ, Director

FRANZ S. LEICHTER, Director

A G E N D A

PANEL 1

1. Madeleine Condit, Korn/Ferry International

2. Peter Wallison, American Enterprise Institute

PANEL 2

3. Michael Radway, Board of Directors, Federal Home Loan Bank of Seattle

4. Michael Middleton, Board of Directors, Federal Home Loan Bank of Atlanta

5. Richard Mroz, Board of Directors, Federal Home Loan Bank of New York

6. Andrew Jetter, President, Federal Home loan Bank of Topeka

7. Robert N. Barone, Chairman, Federal Home Loan Bank of San Francisco

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P R O C E E D I N G S

CHAIRMAN KORSMO: I call this meeting of the Federal Housing Finance Board to order. First, let me extend -- extend, I'm sure, the sympathy of all the members of the Board and everyone here to our colleague Alicia Castaneda, she's not here today because of a family tragedy. She sends her regrets that she couldn't participate and her apologies to our witnesses, but I think we all understand family comes first. In this case, unfortunately, she -- her family has suffered a very serious tragedy. We'll all keep her in our thoughts.

This is the second hearing on the topic of Corporate Governance of the Federal Home Loan Banks. I have a few brief opening remarks before we proceed to take testimony.

But, first, let me open by saying thank you to those who are here to offer your views today. I appreciate the time and thought you've all given the issues before us.

The purpose of today's hearing, as was last month's session, is to collect suggestions and information about possible changes in Finance Board regulations or to the Federal Home Loan Bank Act; potential revisions that would help the Boards of Directors of the

Banks to better identify, measure, monitor, and control the risks on the Bank's balance sheet.

Our first hearing, held January 23, produced a wealth of opinions, observations, ideas, and recommendations. We heard testimony from representatives of trade associations; National Association of Home Builders; the Mortgage Bankers Association; the National Conference for Community Economic Development; the Independent Community Bankers of America; and America's Community Bankers. And received written statements, as well, from the National Credit Union Association and the American Bankers Association.

Today, we build on that testimony with two panels: First, we will hear from two students of corporate governance -- more than students, of course -- Peter Wallison and Madeleine Condit are true experts in corporate governance with extensive experience with financial institutions.

Our second panel consists of representatives of the Federal Home Loan Banks. Four members of Boards of Directors: Mike Radway, of the Seattle Bank; Rick Mroz, from New York; Mike Middleton, of Atlanta; and Bob Barone of San Francisco; and one executive, President Andy Jetter of the Federal Home Loan Bank of Topeka.

The members of our second panel are there every day, where the rubber meets the road, if you will, on corporate governance, driving their institutions smoothly -- we always hope -- but, also, encountering in the real world a few bumps along the way.

Again, my thanks to every here. As I noted at the previous hearing, the level of interest and testifying at both sessions demonstrates, persuasively, that the Federal Home Loan Banks, their members and others who have an interest in the System, take very seriously the issues surrounding corporate governance of these very large financial institutions.

The world in which these institutions operate, the marketplace, the regulatory structure, the political environment have undergone dramatic changes since Congress created the Federal Home Loan Banks in 1932. And I think I'm safe in saying the world will continue to change at a perhaps at an increasing pace.

And, yet, while the world has changed, the basic structure and prerogatives of the Board of Directors of the Federal Home Loan Bank remain largely unchanged from what they were seven-plus decades ago.

It seems axiomatic that for the 12 Federal Home Loan Banks to continue to operate successfully and to

continue to fulfill their public mission as government-sponsored enterprises, their Boards and management teams and their practices of corporate governance must change, evolve, react, as well.

Certainly, the Federal Housing Finance Board has also experienced change, most recently with passage of the Gramm-Leach-Bliley legislation. As I noted at our previous hearing, the Finance Board no longer bears responsibility for managing the Banks, nor does the agency serve as an advocate or buffer for the Banks in public policy debates.

The Federal Housing Finance Board now functions as an arm's-length regulator, charging -- charged with ensuring that the Federal Home Loan Banks are safe and sound so they can serve as a reliable source of liquidity and funding for the nation's housing finance and community investment needs.

The Finance Board's relationship to each Bank's Board of Directors is now one of examination and supervision, determining whether the choices made by each Board of Directors are informed and effective.

Which is all in the way of saying, the responsibilities facing the Boards of Directors of the Federal Home Loan Banks are greater than at any time in the past. To protect the Banks and their housing-finance and affordable-housing missions; to protect the investors in

these institutions' debt; and to protect the public who stands behind the Banks and their congressional charters -- it is incumbent upon all of us to encourage the strongest, best practices of corporate governance.

Just as with last month's hearing, today we gather information, insights, and, if offered, strong opinions. The Board is not at this point looking for consensus or a completed agenda of recommendations. Especially given the current debate in Congress over GSE regulation -- there's a hearing going on, indeed, even as we speak in the Senate Banking Committee -- I believe it is time for fresh perspectives and serious thought. I look forward to a productive session today, and again, my thanks to those who have come to Washington to offer your fresh perspective and serious thought.

As I parcel out my thanks, I would be remiss not to express my gratitude to my colleagues on the Finance Board for their active involvement in the agency's ongoing review of corporate governance issues at the Federal Home Loan Banks. I have previously mentioned the System wide analysis, the horizontal review conducted last year by the Office of Supervision -- a productive exercise, well supported by my fellow Board members.

As well, I appreciate the views and opinions they bring to our discussions of these issues and that they brought at last month's hearing, as well as the work they have contributed in making today's session possible.

On that note, and before we proceed to the first panel, I ask if any of the other Directors would like to make an opening statement?

DIRECTOR LEICHTER: I just want to read the witnesses, I think these hearings are useful, I mean, in throwing some important information on the processes that we use and also improvements that we could make.

I would just say that when we talk of governance, it's not just the governance of the Boards of the Banks, it's also the governance of the Federal Housing Finance Board that we ought to have in mind. Thank you for being with us.

CHAIRMAN KORSMO: Any other opening comments?

DIRECTOR MENDELOWITZ: I just want to express my appreciation to the witnesses. The last hearing was, I think, extremely valuable in focusing on areas where we can work together to try to improve the quality of corporate governance of the Banks and corporate governance of the Finance Board, as well and I look forward to the

contributions of all the witnesses today with great appreciation.

CHAIRMAN KORSMO: Thank you, before I turn to our first panel, let me mention that, of course, we will include all the written submissions in their entirety in the record of this session.

On our first panel are Peter Wallison and Madeleine Condit, who will offer some observations about Board and Corporate Governance.

Mr. Wallison is a Resident Fellow at the American Enterprise Institute here in Washington, where he researches financial markets and banking and financial services. A former general counsel of the U.S. Treasury Department, Mr. Wallison also served as White House counsel to President Reagan.

Last year, the Finance Board invited Mr. Wallison to speak at our annual conference for Federal Home Loan Bank Directors addressing the responsibilities held by appointed and elected Directors, as spelled out in the Federal Home Loan Bank Act. It was a fascinating and valuable presentation. I know I refer to his remarks with some frequency and we'll have him back to speak at this year's Directors' conference at the end of March.

The other member of our first panel is Madeleine Condit. Madeleine is a senior client partner in the Chicago office of Korn/Ferry International, where she is a senior member of the firm's board services specialist team. For the past 18 years, she has assisted clients in building proactive, senior-management teams in a broad spectrum of industries, including financial services, publishing, retail, industrial technology and not-for-profit.

She has also successfully built a specialty practice consulting with corporate boards on issues of governance, compensation and succession planning, and is a frequent speaker on board diversity, board director responsibility and pre-IPO board development.

I note that prior to joining Korn/Ferry, Ms. Condit was a vice president of an investment banking firm, so, certainly, her knowledge of the financial services industry is extensive. I understand you've also been involved in recruitment of Federal Home Loan Bank presidents?

MS. CONDIT: That's true.

CHAIRMAN KORSMO: To both of you, again, my thanks and we look forward to your testimony. Why don't we start with Mr. Wallison?

MR. WALLISON: Thank you very much, Mr. Chairman and to the members of the Federal Housing Finance Board. I'm pleased to have this opportunity to testify this morning and to discuss with the Board the fiduciary duties of the Directors, as I see it, at least, of the Federal Home Loan Banks. What they are and to what purpose they should be directed. This issue seems to me to be particularly relevant as the Board considers reforms in the corporate governance rules applicable to the Federal Home Loan Banks.

From the inception of the Federal Home Loan Bank System in 1932, the Boards of Directors of the Federal Home Loan Banks have been divided into elected and appointed classes. The Federal Home Loan Bank Act initially specified that elected Directors were to, "represent," certain groups of member institutions, while Directors appointed by the Federal home Loan Bank Board or its successor, the Federal Housing Finance Board, were not designated as representing any group. Over the years, Congress has gradually increased the number of appointed Directors so that they now comprise six of the 14 Board members at most Banks, and redesignated the elected Directors so that they are now said to, "represent," the member institutions in various states within an FHLB district. In 1989, in the last major change,

Congress specified that two of the six appointed members should, "represent," consumer or community interests.

In effect, then, there are three classes of Directors on the Bank Boards: Directors elected to represent the institutions in their respective states; appointed Directors who are not designated as representing anyone; and appointed Directors who represent consumer and community groups.

Although the Federal Home Loan Bank Act speaks in terms of elected Directors representing groups, this language should not in my view be taken to mean that an individual Director's decisions -- as a Director -- are to reflect the interests of the group that he or she is deemed to represent. This is because the Act also contains language that applies standard corporate law concepts to the Federal Home Loan Banks, and in corporate law the directors of a corporation owe a duty of loyalty to the corporation that transcends their role as representatives of any individual or group.

In an ordinary business corporation, for example, a majority shareholder may elect all of the directors, but those directors are not permitted to act in such a way as to harm the interests of the minority shareholders. The directors are deemed to have fiduciary

duties to the minority shareholders which they discharge by acting in the best interests of the corporation itself, that is pursuing their duty of loyalty -- irrespective of the specific interests of the majority shareholder. In effect, all the directors must act in the interests of the corporation as an entity, and those interests are seen as distinct from the majority shareholder or shareholders, and from the interests of any other shareholder or group of shareholders.

What does this say about whose interests are to be served in managing the Federal Home Loan Banks?

First, according to the statute, the Federal Home loan Banks are corporate bodies -- i.e., they have potential life -- I'm sorry, perpetual life even though their members -- they might also have potential life --

CHAIRMAN KORSMO: Sometimes, very potential life. [Laughter.]

MR. WALLISON: -- especially considering the debates that are going on today in Congress. But they are intended to have perpetual life, even though their members will change. This points up the fact that a corporation has a legal existence that is distinct from the existence of its members.

Second, the Act says that the management of the Banks is vested in the Directors. And this is very much like an ordinary business corporation, where the board of directors is charged with the management of the corporation, even though this function is in effect delegated to professional managers.

Third, and most important, since the inception of the Act, section 7 has made it clear that the Directors--like the directors of an ordinary business corporation--are to act on behalf of the Federal Home Loan Bank and not in the interests of any member. The Board, says the Act, and here I will quote some language from the act
"shall administer the affairs of the Bank fairly and impartially and without discrimination in favor of or against any member, and shall also extend to each institution authorized to secure advances such advances as may be made safely and reasonably with due regard for the claims and demands of other institutions, and with due regard for the maintenance of adequate credit standing for the Federal Home Loan Bank and its obligations."

This is the only language that spells out the duties of the Federal Home Loan Bank Directors, and it makes no distinction, as you will note, between elected and appointed Directors. Moreover, it emphasizes in three

separate places that the interests of the Federal Home Loan Bank are distinct from and are to be preferred over the interests of individual members.

First, it prohibits discrimination in favor of or against any member, indicating that no representative of a member or group of members may act to prefer the interests of those it represents over the interests of any other member or group.

Second, it requires that advances to any member or group of members be made only in a manner that is consistent with the safety -- the safety of the Federal Home Loan Bank and the claims of other members.

And third, it requires that all advances be made with due regard to the credit standing of the Federal Home Loan Bank, again emphasizing that it is the Bank and not the members that should be the focus of the Directors' attention.

Thus, the Directors of the Federal Home Loan Banks--including the elected Directors and those appointed to represent various interests -- are fiduciaries for the member institutions in just the same way that directors of ordinary business corporations are fiduciaries for shareholders. The fiduciary obligations of the directors of a business corporation, as I mentioned before, are

discharged by taking steps to ensure that the corporation operates profitably and creates value for the shareholders, and the fiduciary obligations of Federal Home Loan Bank Directors are discharged when the Directors take steps to ensure that the Federal Home Loan Bank acts in the most efficient and effective way to perform its mission --a matter I will discuss in a moment.

The directors of financial institutions that are very similar to Federal Home Loan Banks are subject to similar standards. In a Guide for Directors Responsibilities issued by the Office of Thrift Supervision in 1999, the directors of federally chartered savings and loan associations -- many of which are mutual organizations and, thus, are similar in structure to the cooperative form of Federal Home Loan Banks -- are charged with the following duties and I quote:

"As a fiduciary, you must think and act independently and in the best interests of the association. When acting in an official capacity, your personal interests and those of your family and associates must be subordinate to the best interests of the association. You have fiduciary duties of care, loyalty and candor to your association. These duties override your obligations as a

director of a holding company" which would be a controlling party or "other affiliate."

Savings and loan associations, of course, are business corporations, so the duty of directors is reasonably clear: the directors serve the interests of all shareholders by managing the corporation so as to increase its profitability -- economic profit being the reason why members or shareholders of the association have become affiliated in that capacity.

But the Federal Home Loan Banks are cooperative organizations; their purpose is not strictly to increase profitability. This raises a question about how the fiduciary obligations of Federal Home Loan Bank Directors are to be discharged. If simple profitability is not the standard, what standard should Bank Directors use?

In this connection, it is important to note that when the directors of savings and loan associations or ordinary business corporations attempt to assure that their institutions are operating profitably they are fulfilling the purposes of their respective organizations.

What, then, is the purpose of the Federal Home Loan Banks? Most cooperative organizations exist solely to serve the needs of the members, so it would be logical to conclude that the Directors of the Federal Home Loan Banks

fulfill their fiduciary duties when they manage the Banks in such a way as to most efficiently and effectively serve the needs of member institutions. However, in the case of the Federal Home Loan Banks, this seems not to be entirely true.

Under the statutory scheme established by the Act, the Home Loan Bank Board, the predecessor of the Federal Housing Finance Board, was the first entity created and was given authority by Congress to create the districts and the Federal Home Loan Banks themselves. This is very important to an analysis of the question of how the Directors of the Federal Home Loan Banks are supposed to manage the Federal Home Loan Banks. The fact that the Banks were created by the Board, rather than that the Banks and the Board were created simultaneously--or the Banks were created first and the Board created later to regulate them--has significant implications.

Among other things, it means that the members of the Banks did not create the Banks to serve their interests, and are not the successors to anyone who did. In reality, the Banks were created by a government agency under authority from Congress, to perform a government mission. They were not created to serve the needs of the member institutions, except insofar as those needs are consistent with the Banks' government mission.

Although that mission is not described in the statute, we know generally what it is -- to provide financing for residential housing by making that financing available to member institutions.

Thus, in any case where there is tension between the mission of the Federal Home Loan Banks and the interests of the members of the Federal Home Loan Banks, the Directors would appear to have a duty to vote in favor of the mission. And this is true even if that is not necessarily in the interests of the members whom the elected Directors are supposed to represent.

As an example, if there were before a Federal Home Loan Bank--before the Board of a Federal Home Loan Bank a proposal that would be costly to the members -- say by increasing the Bank's cost -- but would materially improve the Banks' mission, the elected Directors, who in principle represent the members, would nevertheless be obligated in my view to approve it, even if that approval were inconsistent with the interests of the member institutions. The mission of the Banks takes precedence. It is, in effect, a higher duty than the interests of the member institutions, even though the Federal Home Loan Bank System is an enterprise that is structured in cooperative form. This would certainly be true for the Directors appointed by the Board,

but it would also be true in my view for the Directors who are supposed to represent consumers or community groups.

What, then, did Congress mean when it provided in the Act that certain Directors should, "represent" various interests? This is a difficult question, but not an unusual one. It comes up in the context of a business corporation quite frequently, and I mentioned it in passing earlier in this testimony. The directors of a business corporation have a fiduciary duty of loyalty to the corporation, even though all of them might have been elected by a single majority shareholder. In a case where there are minority shareholders, these directors are not relieved of their duty of loyalty to the corporation in order to pursue the interests of the majority shareholder; they must discharge their duty of loyalty by managing the corporation in such a way as to enable it to fulfill its profit-making mission. In this way, they serve the interests of the minority as well as the majority.

In the case of the Federal Home Loan Banks, this inherent conflict is resolved by interpreting the term "represent" to describe the process of bringing a particular perspective or expertise to the attention of the Board when it deliberates about a proposed course of action. Thus, Congress wanted certain expertise or perspectives to be

represented on the Boards of Directors of the Federal Home Loan Banks, but did not intend that the Director's ultimate duty of loyalty to the corporation be in any way impaired.

That concludes my testimony, Mr. Chairman.

CHAIRMAN KORSMO: Thank you, Mr. Wallison. As usual, you bring a fascinating perspective to the discussion.

Ms. Condit, why don't we have your presentation and then we'll open the floor for questions?

MS. CONDIT: Great. Thank you very much and, also, I'd like to thank you today for inviting me.

I found Mr. Wallison's testimony particularly interesting. Because when I was first invited to come and speak today, I wasn't sure where the parallels would be between the Directors on the Federal Home Loan Bank Boards and in corporate America.

One of the areas that--I'm going to use my definition of clients that I serve, which will be different than Mr. Wallison's relative to the directors serving the majority shareholders. The majority of my clients of boards are actually made up of independent directors. Rarely do I see people that have boards that have the majority of the representatives from the majority shareholder, unless they are a pre IPO company and they're representing the venture

capitalists. So, I deal in a little different environment than as you defined.

One of the things that I've seen in the last 18 years is that boards have gone from being what I would -- can say rather not rubber stamps, but more of a passive board. In the fact that they supported the CEO and chairman in almost any venture that he would like -- he or she would like to propose. They were quite often interlocking directorships, where one person would sit on the other person's board. And in turn, especially when it comes to the area of compensation, there was quite often a lack of objectivity in possibly seeing that the shareholders -- I would say that the shareholders' interests were, at their best, relative to what -- the amount of money they were making, the amount of stock options.

You can carry that forward to 1990 when the General Motors Board actually made one of the first, sort of preemptive strikes on being an independent board. That, in turn, led many boards to say, let's look at what's going on within our board. Maybe we should be looking at the actions of the CEO and maybe we should be looking around the table as to how we, as independent directors are acting and our involvement.

If you fast forward to the part of the spotlight, which is we're all looking not at Enron, WoldCom, Global Crossings--and talk about good governance. Just within one year before the World Com -- or before Enron imploded, they were voted one of the best -- five best governed companies in the country.

Which takes us to what is good governance? And today, we see many regulations coming out of the SEC, out of the New York Stock Exchange, out of the best practices from the CEO Round Table. That, I think we ought to all keep in mind is just the benchmark, we can all go through and say, do we have the audit committee? Do we have so many expert -- financial experts on those committees? Are people showing up?

But the real question on governance has to do with transparency, independent directors and are they independent both intellectually and emotionally when they enter into the board room?

That comes down to Mr. Wallison's -- part of Mr. Wallison's comments today on who are you serving and how do you best serve the board you sit on? I am not a -- I'm not here to be a major proponent or advocate for using search firms to find your Directors. But I am here as an advocate to say that, as you're looking at Directors, those

individuals who are on governance committees, must be very proactive in looking at the people that they are under consideration.

We never work with a client in today's environment that we do not ask them to do an assessment of their board. We do the assessment. And the assessment not only has to do with what you're bringing -- what – what functional expertise you're bringing to the board; what -- the amount of time you can spend on the board? But, also, relative to issues that the board is going to be facing. And very similar down to Mr. Wallison's comment, what is the mission or what is the objectivity of this company?

I can tell you that there are many directors who have no idea what their company really does. So, therefore, it's difficult for you to know whether you are being an effective director or not if you've never visited a plant. If you've never really walked the floors. If you are not like Home Depot, where you must, as a director, visit so many stores between each board meeting.

So we are looking at directors from a different perspective than ever before. We go through, assess with them, what are their directors bringing? Are they people that have been through crisis management for instance -- which is a very--which for many companies is an issue today?

Have they done M&A? Who, on that board has actually dealt with succession planning? Who has dealt with compensation? And if you look at the number of retired CEOs, how long have they been retired?

I don't want to say that if you haven't been a CEO for five years, you're out of touch. But, certainly, you're not, possibly in touch as much as you were if you had only been out of the board room for two or three years.

We look at that and then, in turn, as we are looking at directors, we talk to these people about what do they plan to bring to the board. How much time do they actually have? A hundred twenty hours per board is minimum. How much time do you actually have to put towards a board? If you're sitting on five or six boards--you do the math. That doesn't leave you much time to keep your handicap at a single digit.

So we really are trying to spend time with them to say what are you bringing? Do you have international experience? Have you been involved in crisis management? Have you built a company or have you only downsized a company? We look at the expertise that people are bringing, as well, and the depth of marketing experience you have or financial experience.

The definition of financial expert is -- if you look at it in its purest form -- will possibly leave out individuals who actually do have financial expertise, but may not be having the title that they’re -- we're looking for. Or they may be a retired audit partner. That's fine, but what did they audit--what was their expertise? If you're a consumer company and they only were involved in industrial, for instance, what are they -- what are they bringing?

So, we are trying to bring today an in-depth and objective appraisal of those people that are looking to be directors. I would say that in many areas, as in when there is an opportunity to make money, one of the things we're seeing our people are going through director programs to be certified. So, therefore, they are certified to be a good director. But if you spend time with them, they possibly do not bring any value to the organization.

So we're trying -- what we look at today are people that can truly be independent; that have every person as a basic expertise that they're bringing to a board is financial knowledge. If you've never read a balance sheet, how do you know what questions to ask?

We are looking at people who have the time, the interest and the passion. And the people who have a

background of saying, “I probably have arrived at a point where I no longer can serve on this board.” And that requires a certain type of individual, as well.

So, we now are looking at people as, I think when you're looking at Director for your Bank Boards, you need to say what is the mission of the organization? What are the issues we're going to be facing over the next three years. You don't need to look out three to five years necessarily -- the next three years. Where is the person that can best bring this expertise and who has the time to best serve our organization?

We do this through a process of having a large database of individuals who currently sit on publicly held companies, as well as individuals that we identify within certain special interests groups. And I mean that by expertise, consumer products, finance, technology -- that we know that we can draw on in order that they will best serve our clients.

This could be done, also, by an organization such as yours -- as the Bank Boards -- by using resources within your organizations to identify these individuals and find out who is interested, who have the qualifications and then, in turn, bring those names to the -- your governance committee in order to pick the best Director going forward.

CHAIRMAN KORSMO: Thank you. Again, Madeleine, we appreciate you being here and lending your expertise to this process.

Which, which, let me ask the first question, perhaps, directed to you. Obviously, these are enormous institutions, I think the smallest now has in excess of $40 billion in assets. You have two Federal Home Loan Banks whose assets exceed $115 billion, they are among the largest banks and institutions in the country. What should a Board that is responsible for dealing with institutions of this size look like? I mean, the current model, as Mr. Wallison pointed out, the statute anticipates a Board with 14 members, eight of whom are elected by the member institutions; six who are appointed from outside the institutions themselves.

While that is the statutory model, there's actually only one Bank that has only 14 members on the Boards. They range up to, I think, the largest now is 19, most are in the area of 16 to 17, the reason for that is there's all kinds of other, I was going to say peculiarities -- I don't know that I want to use that term -- built into the statute that allow Banks that serve a region that has more than five states to have extra Director; as you go up

in the terms of the numbers of elected Directors, the appointed Director numbers rise in concert with that.

So, the reality is, and ironically, perhaps, there's only one Bank that has a 14-person Board and that's the largest Federal Home Loan Bank. Well, it's waffling back and forth between whether San Francisco or Atlanta is the largest on a daily basis. But San Francisco is the only Bank that only has 14 members. As I mentioned, most of the rest have 16 or 17 or 18.

So, what would a Bank Board, in your mind, look like that serves an institution this size -- would -- what kind of expertise would we want to assume exists? And, again, look at that question in a vacuum. Let's assume we don't have the current election rules that limit the voting rights of institutions above a certain size. Let's assume that we move away from the point of process that is inherently -- has an inherently political aspect to it.

But if we were going to reconstruct -- if we were going to start over again. If we were going to construct a Board that would understand the responsibilities that Mr. Wallison identified as to serve the public as opposed to, perhaps, these other loyalties that are inherent in the selection process? What would it look like in your mind?

MS. CONDIT: How often do the Bank Boards meet?

CHAIRMAN KORSMO: Well, at least six times a year. Generally speaking, more often and they also have to have teleconference meetings on a fairly regular basis; and, of course, the committees, also, of the Board need to meet.

MS. CONDIT: I will tell you that with that number of meetings your first constraint will be to find people that have time to sit on the Board. So I think that's a very important thing to realize. You have immediately limited your pool of candidates.

You -- from my perspective, your Board is too large. Fourteen is, by far, too large. I think you would find that the maximum number of individuals on a Board that work effectively together is probably 11, if you wanted to look at a maximum number.

Within that it -- and the number's important. If you get -- if have a Board that gets much smaller than seven, you don't have enough people to sit on the committees. So it's important that you have a good -- a number of people so that you don't have everyone sitting on the same committees.

You need to set up a committee structure which would deal with governance, first and foremost. You would,

obviously, have to have your audit committee and a compensation committee.

I would suggest you also, which I don't suggest for corporate boards, would be a public interest committee. And I'm not sure what that would include but you would -- I think a committee like that would be very important at this--for this organization.

Within that structure, I would suggest to you that all but one person be an outside Director, an independent Director. And the reason I suggest that is that if --

CHAIRMAN KORSMO: Well, I'm certainly glad we have provocative members of this first panel.

MS. CONDIT: Well this is my -- this is my board, you have to remember this is my board.

But if you look at that, what I would see that you would do is that as you said, so appropriately, is that you are -- you must serve the -- the interests of the mission of the organization over the interests of the board, am I correct, Peter in what you said?

MR. WALLISON: Yes.

MS. CONDIT: That gets to be a very interesting tension. Now, one thing you could do and on our ideal board of 11 would be to have four members. I just picked that number out of the air, because I wasn't prepped on this

question. But you could have four members that come from the -- from the Banks that rotate on an annual basis or every two years. You could, whatever your term limits you would like to put in there. If you felt it was really necessary to have representation from the Banks. I -- and I -- those people would rotate off regularly.

How you would pick them, and you're just shaking your head, so you probably think I'm probably roaming into my own land mine here. But -- but I think that if you have the -- if you have that, then you would have, you should not have a majority of the members be from the Banks, but you certainly should have, as I said, four or five that would rotate off on a regular basis.

You would have -- I would suggest that those people would have to stay off of the Bank -- off of the Board for at least one year before being able to be reappointed, so that you don't have a group that continually appears on the Board because they were re-elected each year.

If we have five people, then we have another -- if we have four people, then we have another six, not including the chairman, who would be independent Director. I would suggest to you at that point, that there be people from that have a banking background. Again, we can't, you're probably

looking at a retired banking person from a--however you want to define that. From a -- from a bank -- with a banking background. Possibly that person would not have to be a CEO or a COO, but you would look again at the expertise they would bring that would be of value. And I think you need to get away from the feeling that it has to be a chairman or a CEO or a C -- COO title in order to best serve you because of the way you work.

You might find that you would, someone from your Board might be from a company or a corporation that also serves the public, such as a utility board. Looking, again at some of the issues facing your constituents. I would suggest you, also, that you would -- you should bring in some corporate expertise. And that could be either from the marketing arena. And I think that one of the things that institutions like yours sometimes do not look at is the value of marketing. What is the message you're sending out to your constituents?

And I would venture, also, to say, as I said in the corporate arena where that person would come from would depend on what best serves that area.

CHAIRMAN KORSMO: Very interesting. This isn't the question that I was going to ask Peter, but I'd ask you now to react to what Madeleine said.

MS. CONDIT: Yeah, you think about this a lot.

MR. WALLISON: Well, I do, but I think of it mostly in terms of business corporations. So, I as Madeleine was talking, I was trying to think about the difference between the Home Loan Banks and business corporations. And whether what she is saying fits with my concepts, as I've thought about it in that other context.

First of all, the definition of an independent director today, after Sarbanes-Oxley, is basically someone who has no association with the company involved. You're not retained as a lawyer, you're not retained as an investment banker, you are -- you do not do work as a consultant for the company. So, you could actually be an independent director and still be, if we're putting it into the context of the Home Loan Banks, you could still be a member of or a designee of a member of the Home Loan Bank, that is, some member bank and still be independent in that sense. That is to say you are not, in any sense, compensated by the Home loan Bank of which you are a Director, so you would be independent in that sense.

Now, however, if what Madeleine was suggesting is that people have--be independent in the sense that they have no connection with the members, I'm not sure that I actually would agree with that proposition. Because one of the

weaknesses that I see in the whole notion of independent directors on corporations -- business corporations -- is that they know very little about what the company does. And their decisions tend to be very conservative for that reason. They are afraid of risks, they are afraid to take the -- take the word of the management and -- for a number of reasons -- and that does, I think, weaken our corporations. That's a different question from what we're talking about here.

But there is still the problem of not having sufficient knowledge of how the Banks actually operate that could make an independent Director -- that is, someone who comes from outside the industry -- less valuable as a Director. So I guess those are my --

CHAIRMAN KORSMO: And the learning curve --

MR. WALLISON: The learning curve is very, very long and Madeleine's completely right that the time commitments that are now involved makes it very hard to find someone who is going to be interested in serving on one of these Boards. We haven't even discussed the question of compensation. I don't even know what kind of flexibility there is in the compensation of Directors for all the time that they have to spend.

But it would be easier to find someone from the industry to serve on a Board if you didn't regard that person as non-independent, than it would be to find someone completely outside the industry to serve on the Board because not only would that person have to learn how the industry operates and what the major issues are and what he or she should be concerned about as a member of the Board. But would also have to serve in the capacity of a Board member, making decisions on a day-to-day basis, based on whatever the issues are before that particular Board.

I see -- I see two different sides to that issue.

CHAIRMAN KORSMO: Right now, of course, there's all kinds of restrictions on who can belong on a Board and what the compensation levels are, either contained in the statute or in our regulations. We do have, ironically enough, some, at least one interesting situation where, because there's a prohibition about for appointed Director to be employees or to hold shares of stock in a member of a given Bank. We have one interesting situation where we do have a banker whose serving on the Board as an appointed Director on the Board of one of the Banks. But the institution where he's employed isn't a member of that particular Federal Home Loan Bank. And so, it probably gets to your point, but he's an outside Director, in a sense.

MS. CONDIT: Mm-hmm.

CHAIRMAN KORSMO: But brings the kind of expertise and background to the Board's deliberations. I've taken too long, let me open the floor to my colleagues. Director Weicher.

DIRECTOR WEICHER: First I'd like to start by explaining my facial expression.

[Laughter.]

DIRECTOR WEICHER: When you said seven Director, I was reminded that I also serve as my colleagues know, as the Secretary's designee on the board of the Neighborhood Reinvestment Corporation, where we have by Congressional Act a board of six, not seven, not eleven. And we have three-person committees and I was thinking of the personnel committee turned into the search committee this fall when the executive director resigned and with the chairman and the members of the search committee, we had 4/6 of the board as the search committee. And I think the idea of six, it does become a bit of a stretch some of the time.

I was also thinking about this in the other direction. Do you have any sense that the size of the board relates to the size of the corporation. If you have a $100 billion corporation, do you have a larger board than the $1 billion corporation or anything along this line?

MS. CONDIT: That has not been my experience. And you will find some of the better, the larger boards which have best practices are a smaller board, in the 9- to 11-person.

DIRECTOR WEICHER: The boards of the large corporations?

MS. CONDIT: Quite often, mm-hmm.

DIRECTOR WEICHER: Is there a--would you expand on that a little bit, the problems you get in a larger number of boards -- board members?

MS. CONDIT: A number of my clients are actually downsizing their board. From the time when they may have had 13 or 15 members down to 11 or 13. Because they find that it runs more efficiently. They are -- it's more difficult to find directors now. And their feeling is that it is a time to actually have directors that add more value, as opposed to a larger number of people. It also is, a number of the boards have interlocking directorships. And as those people are coming up for re-election, they're not filling their -- those seats.

But there is definitely a feeling that we're looking for a different type of directors than we were before.

DIRECTOR WEICHER: Do you have any sense of a difference in this respect between for-profit and non-profit entities?

MS. CONDIT: Well, the non-profit boards that I am a member of have traditionally been fairly large boards that are run by an executive committee that makes the majority of the decisions so the not-for-profit board will meet as a whole four times a year or three times a year. The executive committee will meet every other month.

And so, I have, that's been my experience. And we primarily have been driven by the development component of the organization, so we spend more time in thinking about how we're going to raise money for the organization. And, therefore, it's--you do need a larger board.

The smaller boards that I've sat on, where there's not a fund-raising drive in quite the same way, the boards are smaller.

DIRECTOR WEICHER: To follow-up.

CHAIRMAN KORSMO: Sure.

DIRECTOR WEICHER: This is for Peter, in particular. At the last hearing and in another context, I characterized this entity and GSE's in general as something created to serve a public purpose and given certain privileges to serve that purpose and expected not to lose

money in the process. And it seems to me that's very much what you are describing here with the particular focus on the mission.

MR. WALLISON: Mm-hmm.

DIRECTOR WEICHER: And I thought your discussion at the end of the history of the creation of the System was quite relevant and something that I hadn't thought of in this context.

I asked the two panels in the -- at the first hearing what they--and this is not quite the subject of today's -- of either hearing -- but I still want to ask the question, anyway. Whether you have any sense of the extent to which -- either the Banks individually or the Banks as a whole -- could be moving more in the direction of taking more risks serving the mission more extensively. Or moving more in the direction of being concerned about their safety and soundness -- the balance that it seems to me needs to be struck between these two objectives. There's always going to be a tension between them.

I was just wondered if you have any thoughts on that?

MR. WALLISON: I agree with you completely that this is a question of balance between risk and prudence, so to speak. In fact, that's what I was responding to when I

was talking about independent directors in ordinary corporations.

My own view, as is true in the private connection with private ordinary business corporations, is that the balance should shift somewhat toward risk. That if you are charged with a government mission and the--on the other side, the question is whether you are going to preserve your institution as a solid un- -- non-risky organization, the directors ought to consider whether they can take somewhat more risk than usual in order to accomplish a government mission. But they always have to try to achieve that balance.

My view, if I were a director would be to press more strongly on the issue of government mission than I would on prudence. But that is a very personal matter, I think, on the part of each director.

DIRECTOR WEICHER: Well, I asked you for your judgment on it.

MR. WALLISON: Yes.

DIRECTOR WEICHER: I appreciate getting it.

DIRECTOR MENDELOWITZ: I have a couple questions, but before I ask them, I wanted to thank the panelists who were very helpful and very interesting presentations.

And in the interest of full disclosure, I

have to put into the record that I've read some of Mr. Wallison's work. I've had the chance to hear him speak and I am an enthusiastic fan of your work. Even if I don't agree with your conclusions, I always benefit from your analytical insights. And I greatly appreciate your participation.

Madeleine, please don't feel slighted, it's just that we haven't met before and --

MS. CONDIT: I will just send you some of my articles.

[Laughter.]

DIRECTOR MENDELOWITZ: Terrific. I look forward to it. But, Peter, I actually have a question. You -- I really, like Commissioner Weicher, I really found your analysis on responsibilities of a member of the Board of Directors to a GSE as really very insightful and very clearly presented.

The difference between a director of a private corporation whose fiduciary responsibilities maximize shareholder value versus the director who comes to serve the public mission.

Everybody talks about the Home Loan Bank System as a cooperative system. But the reality is, we have 12 Home Loan Banks that are cooperatives. But the System

itself is not a cooperative. The System is 12 independent cooperatives. But they are linked together because of joint and several responsibilities for the debt.

And one of the things I was interested in is trying to explore ways of strengthening the safety and soundness of the System through enhanced mutual surveillance. Each Bank looking over the shoulder of their brother or sister Banks. And in order to do that, we need a level of disclosure that would permit the Banks to enhance their mutual surveillance. Do you have any suggestions about the desirability of mutual surveillance, value of it, and what kind of data, of course, would be useful to do that?

MR. WALLISON: Well, this is a very interesting question, isn't it? Banks, ordinary banks do this regularly, because they have deposits in one another's accounts. And that is one of the ways that, before regulation became such a significant activity on the part of the government, banks actually surveilled one another. And that is, you would not put your deposits in another bank until you had reviewed thoroughly the financial condition of that bank. And, particularly, the quality of its capital.

So, I think, not -- and I have to say here, that I'm not an expert on the Federal Home Loan Bank System, far

from it. But I would say that one of the ways that you could induce this kind of surveillance and make it meaningful to the Directors of each of the Home Loan Banks would be to -- if this were possible -- to have mutual deposits as between the two, so that there would be a basis for some kind of disclosure to each -- by each Bank to each other Bank that would enable each Bank to get a sense of the quality of capital of the other Banks.

And there could be a point at which a Board of directors and from them, by delegated authority, the managers, might say, well, we're not actually going to deposit any more money in your Bank because we are not actually very happy about the quality of your capital.

That can be done.

DIRECTOR MENDELOWITZ: But in a sense, because of the joint and several responsibility for the debt obligations of the System, the Banks should already be incentivized to engage in mutual surveillance.

MR. WALLISON: Not necessarily, actually. That as you were describing it, my sense was it gives some Banks an opportunity to free ride on the System. Because they are not bearing the full risk of whatever losses might occur. The System bears the losses, they can take the risks. And, in fact, as you were talking, I thought back to John's

question. And I said to myself, well, actually my answer there might be somewhat affected by a recognition that there is this opportunity on the part of Banks to -- in effect -- free ride on the entire System.

If you are raising funds, for example, I understand that the Home Loan Banks raise funds jointly through a single issuer --

DIRECTOR MENDELOWITZ: Right.

MR. WALLISON: -- and they back jointly that obligation. Well, that enables a Bank that is not well managed, that it does not have good quality capital, for example, to raise funds when, in an ordinary case, the market might not advance funds to that Bank.

DIRECTOR MENDELOWITZ: This issue of the potential free-luck rider or what's the term? There's a term-of-art—

DIRECTOR WEICHER: Free rider.

DIRECTOR MENDELOWITZ: There's another one. But, I mean, basically, what we're talking about is a wedge between the inherent risk of an institution versus the cost of funds because of mutually assured repayment --

CHAIRMAN KORSMO: Moral hazard.

DIRECTOR MENDELOWITZ: Moral hazard, that was the word I was looking for, moral hazard.

KORSMO: I outdid the two doctors.

DIRECTOR WEICHER: Director Mendelowitz is in front for the first time, the right term is free rider.

DIRECTOR MENDELOWITZ: I've actually thought about this a lot because for the very reasons that you've articulated, it's something that I've struggled with and anytime you have a free-rider situation, you have the potential for distortions. Not withstanding the fact if you have a government enterprise --

MR. WALLISON: Yes.

DIRECTOR MENDELOWITZ: -- you have a distortion of the market anyway. But I decided that, in fact the free-rider problem is significantly less of a problem than you might think because of the very structure of the System for two reasons: One, before a joint and several kicks in, the errant institution is going to have it's capital wiped out. So that the members of that institution who own that institution suffer very significant losses. So that they have a very clear incentive to make sure that anything they can control that would prohibit the need to call on the joint and several will be done simply because they stand to lose a tremendous amount.

Second, under current statutes, if a Home Loan Bank is short of its required minimum regulatory capital -- just like the old financial institutions of 100 years ago --

members, basically can be subject to a capital call. So that because of the capital call and the fact that the capital itself has to be wiped out, the free-rider problem is less of a problem. I think so that, I'm less concerned about that, but I do believe that the potential contribution to save the insolvents from enhanced mutual surveillances could be quite significant. Because one Home Loan Bank, better than anyone else, can understand what's going on in another Home Loan Bank.

MR. WALLISON: That's right.

DIRECTOR MENDELOWITZ: And so, I'm sort of interested in what kind of disclosure could enhance that strength and promote it.

For example, do financial statements as supervised by the SEC provide the kind of data that would make enhanced mutual surveillance better? You're an expert on this, too, so --

MR. WALLISON: Well, I don't know that I'm an expert on this or anything else. But I would say this. And that is that the idea of mutual surveillance coming out of mutual obligations is challenged somewhat by what is going on in the banking business today. Now the two are not--are not directly similar because there are several thousand banks, 10,000 banks and there are only a dozen

Federal Home Loan Banks. So there could be a difference in this respect.

But in the banking business, all banks are, today, after FDICIA, in 1991, responsible for the losses at any bank that is suffered by the FDIC in paying off that particular bank. It's not well known. Most people think the taxpayers are responsible. But, in fact, the FDIC has been given the authority to tax all banks to recover any losses it suffers on a single bank or a group of banks.

Now, you would expect in that situation, the banks would be very interested in knowing about the condition of all the other banks. However, that has not, in my experience, happened. Now it may well be that since FDICIA, there haven't been any serious losses, so what the banks have to pay in premia as a result of this new arrangement, has not been large enough, really, for them to worry about the problem. And, maybe, if one day, we go back into a situation where we have serious losses and the banks really have to pay out large amounts of money, they will create the staffs and the other things to do it.

But it hasn't happened yet and so I think there is sort of a sense--I have--that these mutual-loss arrangements don't really--don't really work in theory, even though--I

mean, don't really work in practice, even though you think they would in theory.

DIRECTOR MENDELOWITZ: That's an interesting analysis. I have to think about it because the obvious next question is: Is there ways to incentivize the System. I'm a firm believer in incentives, rather than punitive regulations as a way to get people to do the right thing.

As a way to incentivize the System to make this joint and several more of a force for the safety and soundness of the System. And you don't have to answer it now, but just --

MR. WALLISON: It's something to think about, and I will -- I will try to give you an answer at some point.

DIRECTOR MENDELOWITZ: Thank you. And based on your past work, I'm actually looking forward to it with great anticipation because I know it will be interesting and insightful.

MR. WALLISON: Thank you.

DIRECTOR MENDELOWITZ: Madeleine, if I could ask you a question.

MS. CONDIT: Yes.

DIRECTOR MENDELOWITZ: You talked a little bit about what a Board should look like in terms of its operations. I wonder if you could elaborate in terms of

minimum standards in a the way of a -- for example, Mr. Wallison indicated that Boards of Directors at Home Loan Banks are charged with managing the Banks. That's their job. And what do you think is the appropriate structure for a Board that manages a responsibility. And secondly, what are the appropriate procedures -- not just committees, but what are the appropriate procedures? How does work get done in an effective Board?

MS. CONDIT: I think that when you look at how a work gets done, an effective board is something that is a continual balance act within corporate America. The question is, how much information is too much information that you give your directors?

Transparency is a word that we throw around today constantly. And so, many CEOs, rather than--in order to be transparent provide inches of materials to each directors. Not necessarily the quality but how thick is that book that they get.

And one of the questions is the effectiveness of the information they receive. So, if you look at some of the best practices companies, and I would like to cite Emerson Electric, for instance, they probably provide to their directors insightful information which their Chairman and CEO, David Farr, spends a lot of time putting together

to make sure that it gives the best information with the least amount of paper possible.

And there you have a perfect example where the CEO spends a lot of time making sure that he is writing the right information. The CFO, the information that he provides, is the proper information, so I think that it comes down to a CEO actively being involved in the amount of information that goes to the director, as opposed to offsetting it to -- giving it to the corporate secretary and saying, you put together the books.

So it comes down to a CEO being very involved in what the directors get and knowing their directors. A CEO who does not properly use his or her directors as part of their cabinet, part of their sounding Board does not know what the questions are that they're interested in and what type of information they need to be effective.

So, it comes in, I think in two different ways: Knowing who your directors are; knowing what they're interested in; what they need to know in order to make the right decisions and then being a
chairman and a CEO that is actively involved in the preparation of the materials and make sure that it's -- and make sure it gets out in a timely manner, as well.

That's how you do business in the most efficient and effective way.

DIRECTOR MENDELOWITZ: What kind of records, for example, if a Board were to entertain a policy decision for the institution that they're responsible for, and there's no legal analysis that this is within the scope of law; if there's no analytical assessment of what the benefits, costs, risks, opportunities are of this act, they just adopted something willy-nilly without that kind of strong foundation, would that be considered good governance?

MS. CONDIT: No, and I think one of the things--it goes back to a director looking at two things: the formal documents and the informal documents. Asking to make sure that at the -- first of all being involved in the strategy of the operation, of the company. Strategy sessions should not be something you do on a weekend once a year. It's an ongoing part of being a director. So the director needs to be involved. First of all in understanding strategically where the company is going, looking at the formal documents that are presented to them and then informally asking to have those people involved in any major strategic decision to meet with the Board.

And so they're -- I feel that one of the things that we are doing right now and that we need to be very

careful about is not over-regulating corporations to the point that they no longer can conduct business. And certainly we get close to that at some points in time.

CHAIRMAN KORSMO: At the risk of --

DIRECTOR MENDELOWITZ: Mr. Chairman, I just have one other quick question.

MS. CONDIT: I'll have a quick answer.

CHAIRMAN KORSMO: Go ahead.

DIRECTOR MENDELOWITZ: There are a number of entities out there that give scores for the quality of corporate governments. Governance Metrics International is one, there's many others. We just did this single-issue System wide review of corporate governments in our System. Do you find that there's any benefit to having sort of a metric that gets assigned every year that would be useful to us to annually to prepare a metric to assess the quality of corporate governance in the System and then run the number each year? Is there a value to that?

MS. CONDIT: There's a value to that as long as its a matrix that you develop and that you administer. I think you'll find, again, that if you look at a lot of these score card companies that are coming out, if you're a member and you might pay a little bit more than someone else, your score goes up. So you need to be very careful that when you

look at these as--and, for instance as an institutional investor that you find out where--how much this person has contributed to the actual analysis and scoring. So, there is definitely a reason to do that. If it's something that you develop or you have an outside source develop on your behalf that is relevant to the Banks.

But to buy this, gets to be a little tricky. If you don't look behind the magic curtain.

DIRECTOR MENDELOWITZ: Thank you very much.

CHAIRMAN KORSMO: Director Leichter, do you have any questions, comments?

DIRECTOR LEICHTER: Yes, I just want to thank both Madeleine and Peter. Peter if I can ask you a question. I first want to say, I think your presentation was really an excellent lucid analysis of the responsibility of members of the Board of Directors of Federal Home Loan Banks. I thought it was so good that as you were presenting it, I thought, well, this is something we ought to put in the hands of every Director and maybe you could think about distributing it, since we're having a Directors meeting.

CHAIRMAN KORSMO: Well, we're having Mr. Wallison on the program at that Directors' meeting.

DIRECTOR LEICHTER: All right, well, I think if you give this it would be very effective. But there's only

one thing that--one sentence in there which puzzled me a little bit.

And let me pose the question first before I identify the sentence. But the premise that you set forth, as I understand it, applies to all Directors elected, as well as appointed.

MR. WALLISON: Yes, sir.

DIRECTOR LEICHTER: And maybe I'm just nit picking, but there's one sentence where you go and you set forth the responsibility of the Directors. And then you say, this would certainly be true for the Directors appointed by the Board but it would also be true for the Directors who are supposed to represent consumer community groups. But, in fact, it's true for all Directors, not only those appointed by the Boards; not only consumer and community representatives, but also elected representatives. It may be so pretentious to suggest, I think that point needs to be made.

MR. WALLISON: Yeah, that was sort of an a fortiori point that I was making and that is, if it applies to all directors then it is also going to apply to these particular Directors who are designated by Congress and were recently designated by Congress as, "representing" certain groups.

DIRECTOR LEICHTER: I understand how you meant it.

MR. WALLISON: That's what I meant.

DIRECTOR LEICHTER: Now, I think it's excellent. Let me just ask you one other question, if I may, because I know you analyze and look at the various financial regulators. You look at the Federal Reserve. The Federal Reserve is a system of advisory boards that it sets up, where the members of the Federal Reserve meet periodically with these boards one of them with consumers and so on.

Do you find that that's been an effective way for the members of the Federal Reserve to interact with people who are interested in the banking system?

MR. WALLISON: Although I've never been in a meeting with -- of those groups with the Board, in general, I believe that to the extent that any government official can have an opportunity to meet with the groups and individuals who are affected by that official's decisions is extremely valuable. And I am one who is somewhat concerned about the Advisory Committee Act, which has been in effect now for about 20 years -- and was when I was in the Treasury Department a serious impediment to having the opportunity to get the candid views of people outside the government.

Now, for those advisory committees, as I understand it at the Fed, they're exempted, because of the

nature of the Fed's activities. But I believe if you could get the same exemption; that is: this Board could get the same exemption, it would be very helpful to you to be able to meet and listen to the views of people candidly given in confidential circumstances, which is, obviously, very hard to do under other circumstances.

DIRECTOR LEICHTER: Thank you. Of course, while you're perfectly right that the Federal Advisory --

MR. WALLISON: Committee Act.

DIRECTOR LEICHTER: -- Committee Act does place limitations on how you can set up these committees, there's nothing in the Act that would prevent this board from setting up these committees. We'd have to follow the pattern laid out by the Act, but we could do it.

MR. WALLISON: That -- that is true, but the press would have to be present at the meetings.

DIRECTOR LEICHTER: Yes.

MR. WALLISON: And that is the -- that is the impediment because, then, at that point people are -- begin to consider the constituencies that they represent outside. They're not providing candid views anymore, they are providing the terms that they ordinarily provide when they are speaking publicly and that's just not as useful. You can get that from reading the newspapers.

DIRECTOR LEICHTER: It's a valid point. Thank you.

MR. WALLISON: Thank you.

CHAIRMAN KORSMO: Any other questions for either of our panels. I apologize, I'm going to go back and ask something -- it's something that actually, interestingly enough, Mr. Wallison said and I guess it was also in your testimony, too, Ms. Condit, one point and I wanted to be sure and ask about it because it was something that came out of our horizontal review, too. And while it isn't strictly related to the question of how our Boards function or are organized, one of the recommendations that came out from our horizontal review is most of the Boards are effective in selecting and retaining the skilled senior managers. They can further these efforts by, however, and one of the points that was made was: Considering external, as well as internal candidates when filling executive management positions.

Now, obviously, in the position you're in, you have been involved in searches for Federal Home Loan Bank presidents, but how important do you feel this particular charge that came from our Office of Supervision, would be in its relationship to the functions of the Federal Home Loan Banks?

MS. CONDIT: I personally feel that it's -- depending on where the Bank is going. I think, again, that's the key. Is what is the Bank going to be facing over the next few years? And what is the different types of expertise that would be needed in order to achieve the mission that you're going to be or the strategy that you're looking at.

One of the things that when you hire a third-party to conduct a search for you is that there is a great deal of time spent understanding what it is that you're going to be looking for; what attributes, both the expertise and the sort of the softer parts of that, which may come from personality, culture change -- which we're seeing a lot of right now--as we're doing work for organizations, such as yours, in order to meet new challenges that are occurring.

And then, to draw or to develop a broad pool of candidates that have those attributes. And at the same time having all the internal candidates as part of the process. And they are considered and treated as if they are an external candidate, on the same level as those individuals. There are times it's certainly the internal candidate is the final choice. And there are times that an external candidate is the final choice.

What it will give you is the -- to look outside and say, you know, we have done a thorough search and this is the best person.

CHAIRMAN KORSMO: Thank you, again, while that wasn't strictly on point, I thought as long as we had your expertise here, we would avail ourselves of it.

Any other comments, questions for either Peter or Madeleine. Peter Wallison, Madeleine Condit, absolutely fantastic testimony, very helpful and we very much appreciate you taking the time to be here with us and contribute.

MR. WALLISON: Thank you.

MS. CONDIT: Thank you.

CHAIRMAN KORSMO: Why don't we take a three-minute stretch break, we'll bring up our second panel and then we'll reconvene.

[Off the record.]

CHAIRMAN KORSMO: All right, our second panel today includes speakers from Federal Home Loan Banks Boards of Directors, as well as a Bank president. I previously mentioned the Office of Supervision System wide Review of Corporate Governance last year. A process that I think all of you participated in and we thank you not only for that, but, also, for your willingness to be here today.

Let me quickly introduce the members of our second panel: Michael P. Radway, a consultant in Portland, Oregon, who is Chairman of the Board of Directors at the Federal Home Loan Bank of Seattle. In an earlier life, Mike looked at the Federal Home Loan Banks from the perspective of a staff member for Representative Paul Kanjorski, so he brings us kind of a two-for-one shot today.

Rick Mroz, Richard S. Mroz, is a member of the Board of Directors of the Federal Home Loan Bank of New York, where he chairs the External Affairs Committee. He's of counsel with Stradley, Roane, and Stevens and Cherry -- excuse me and Young, of Cherry Hill, New Jersey.

Michael L. Middleton is Chairman of the Board of Directors of the Federal Home Loan Bank of Atlanta. He's also chairman and president of Community Bank of Tri-County in Waldorf, Maryland.

And Robert N. Barone, is chairman of the Board of Directors of the Federal Home Loan Bank of San Francisco. In his day job, he's director and corporate secretary for Nevada State -- that's not right, Nevada, right? I was chastised not too long ago for-Nevada Security Bank in Reno, Nevada.

Finally, of course, Andy Jetter is President of the Federal Home Loan Bank of Topeka. Why don't we start

with this end and we'll work our way toward the window. So, I'll open, Mike, with you.

MR. RADWAY: Thank you very much. Good morning, Mr. Chairman, Secretary Weicher, and Directors Leichter and Mendelowitz.

I am Mike Radway and I'm in my sixth year as a member of the Board, and Chair, of the Federal Home Loan Bank of Seattle.

I'd like to quickly thank you for inviting us to testify on the critically important issue of corporate governance, which we all know is more important today than it has been in quite some time.

The practical implication of corporate governance issues has been of paramount importance to the financial institutions, the neighborhoods, the businesses, the families of the nonprofit housing and economic development organizations that we in the Federal Home Loan Bank System serve every day and, also, to me personally.

I know that I'm accountable for the safety and soundness of the Federal Home Loan Bank in Seattle. And while I'm not alone in that role, I share it with 17 other Directors on my Board, as well as with a management team, I consider it my job to ensure that the financial management of this $46 billion Bank is effective over the long term;

including the proper stewardship of our shareholders' capital.

That's a fairly staggering responsibility when you consider that the funding provided within the Seattle Bank's district fields housing finance, affordable housing initiatives, and economic development for communities from Pago Pago to Walla, Walla, Washington -- it's a fairly broad region.

CHAIRMAN KORSMO: Isn't that Pango Pango?

MR. RADWAY: I don't think so, but I could be wrong--I have not yet been to all parts of my Bank's region, although that may yet happen, I suppose.

CHAIRMAN KORSMO: You have been to Walla Walla, though, I trust?

MR. RADWAY: Yes, yes. The Seattle Board shares with you, our regulator, the Treasury and the Congress the sense of urgency that is so pervasive today regarding the need for increased accountability and responsibility. And we've worked hard to significantly strengthen the leadership and oversight of the Seattle Bank.

Over the course of the last year, our Bank's Board has created, adopted and publicly disclosed a set of core principles and guidelines relating to corporate governance,

realigned our Board/Committee structure to more effectively oversee all facets of the Bank's operation.

Upgraded our education and training program for Directors and established a Web site that provides Directors with faster access to a wider range of information critical to their Board's roles.

I also want to recognize the foresighted diligence of the Finance Board in overseeing and supporting sound corporate governance practices across the Federal Home Loan Bank System and, particularly, the horizontal review that was done last year, under your leadership, Mr. Chairman, of corporate governance. At all the Banks, we found both the document which analyzed the activities of the other Banks and described some of the best practices that were being engaged in at those Banks very helpful to us, as well as the individual review that we received from the supervision staff of our own Bank's operations.

I also think it's important to corporate governance the initiatives that the Finance Board has undertaken over the last several years to strengthen the Office of Supervision and Examination at the Finance Board. Clearly, with the increasing complexity of the balance sheets of the Banks, it's important for our regulator to beef up in this area. And I will say that the Banks, as

those who ultimately pay for that increased supervision had no complaints and, in fact, are very enthusiastically supportive of the fact that --

CHAIRMAN KORSMO: Well, that's not entirely true.

MR. RADWAY: Well, this Bank will go on record in that regard. And since it's been asked in the earlier panel about whether we represent the interests of, in case of audit new directors of the member institutions that we represent. Or that sort of broader interest of the Bank, I think it's important also to note that last year, as part of its strategic planning process, at my Bank, we determined that we, too, needed to make a similar upgrade in our capabilities -- both technologically and in terms of individuals and personnel in order to do accounting and internal controls and our management of the risk on our balance sheet and, accordingly, made the decision to have a really unprecedented increase in the budget of our Bank of a 50 percent increase in one year, the addition of 48 additional staff positions, most of which are highly technical in nature. But will give us the ability to do the kind of quantitative analysis that we think is necessary to make sure that going forward we are able to manage our balance sheet appropriately. And, also, provide the kind of -- the world-class disclosure which our regulator and which

the public are demanding of the Federal Home Loan Bank System.

Today's hearing is further evidence of the Finance Board's commitment to build a regulatory structure that offers the 12 Federal Home Loan Banks the consistent effective resources, processes and guidelines that continue to enhance the safety and soundness of the Bank System, which, as we all know, has not suffered a credit loss since it's creation over 70 years ago.

To that end, and since you asked us for specific suggestions that we might make in this area, we have four specific recommendations which were discussed by my Board’s Corporate Governance Committee a little over a week ago. And then, subsequently, by our full Board.

Recommendation number one is that we support the devolution of the selection of Public Interest Director appointments to the Boards of the individual Federal Home Loan Banks.

And in making this recommendation, it is not intended as a criticism of the activity of the Finance Board in any regard in this matter. But, rather, realization that best practices in the general corporate world suggest that the Boards of the individual Banks are in the best position to determine what skill sets it needs. What holes it may

have in terms of experience in knowledge base. And are probably better positioned to make the recommendations that are necessary to fill these positions than the individual Finance Board is.

There also has, historically, been over time some problem at the Banks in terms of timeliness, sometimes of appointments of Public Interest Directors. And, occasional, swings back and forth in the pendulum in the experience gap of the Public Interest Directors. And we think that the Boards would probably be more cognizant of whether that pendulum has swung too far in one direction or another in terms of either too much experience and not enough fresh blood or too much fresh blood and not enough experience on the Boards of the Banks.

The second recommendation that we have is to enhance Director expertise. This relates to our first recommendation, ensuring that we have Directors with the expertise and experience to understand and oversee the financial complexities of our organizations, as well as the housing finance, economic development and affordable housing needs of our Bank districts.

If selection of the Public Interest Directors were devolved to the individual Banks, it would give us the ability to fill gaps as I mentioned earlier. And since we

don't, under the statute, have the authority to effect in a significant way, the -- in fact we're prohibited from having any major impact on the election of elected Directors, it's sort of all the more important that those Directorships for which there is some discretion, the appointments be made to fill gaps and meet needs.

And then secondly, an integral important part of enhancing Director expertise is to create an ongoing Director development program that continually builds expertise both for elected and appointed Board members. And that means stepping up both the training at our individual Banks. I think some of the training that gets done on the System wide level and making it an ongoing expectation.

Recommendation three is that the Director compensation issue be devolved back to the Banks where it was prior to the passage really of the Gramm-Leach-Bliley Act. That act limited Directors'compensation to $15,000 a year, with slightly higher amounts for chair and vice-chair and with annual COLAs, starting in 2001. And, clearly, the increased responsibilities that have flowed both from that Act, from the prospective impacts of enhanced disclosure, the impact possibly of Sarbanes-Oxley Act compliance and the activities that were described, I think, by a number of the panelists on the first panel, indicates that the demands for

Board members are such that -- that the statutory limits may not be completely reasonable. And that the Boards, themselves are in the best position to determine what the appropriate amounts are that, that -- in terms of best practices is, I think, the way almost all other Boards are -- act, including the Boards of the other housing GSEs.

And as a control to protect the Public Interest, we think that there should be sort of mandatory public disclosure of all -- any financial arrangements, compensation of Directors so that the sunlight will be the best disinfectant of preventing any initial abuse in that area.

And, finally, our fourth recommendation with regard to Board terms, which I know is something that you have been interested in. We believe that if Public Interest Director appointments are devolved to the individual Banks, thus, allowing the institutions to select Directors with higher levels of financial and community economic development expertise, then the current three-year terms may suffice.

That the issue which we think is encouraging some people to suggest the term should be lengthened from three years to a longer period, four years or whatever, has more to do with continuity and experience levels on the Boards.

The average experience level for appointed Directors in the System is just slightly over one year. I think that's probably a case where the pendulum has swung too far in one direction.

But if you facilitate changes in that area, then it's probably not necessary to lengthen the term and you have the ability, in the case that, frankly, you make a mistake and a Director's not meeting your needs, you can get rid of him. And I would point out from your perspective, I know the Chairman, in particular, has talked often of maintaining the bright red line between the regulated and the regulator.

And one of the ultimate powers that you as the Finance Board have is the authority to remove Directors for cause. And, frankly, if you devolve the appointment process to the boards, you're probably more likely to actually exercise that removal authority than you would if you are being put in the embarrassing spot of potentially having to remove somebody that you appointed in the first place.

Thank you very much for the opportunity to testify today. We appreciate your looking at this issue and look forward to hearing from my colleagues.

CHAIRMAN KORSMO: Mike, Mike.

MR. MIDDLETON: Mike. Thank you, Mr. Chairman and members of the Finance Board. Good morning.

I appreciate the opportunity to present our Bank's views on the importance of governance of the Federal Home Loan Bank in an evolving world.

As a Federal Home Loan Bank Director for over eight years, I know how important it is to understand the Bank's operations, general financial management in order to effectively oversee the business strategies and program development and risk management.

I also appreciate how much the Bank System has changed over the last decade. When I joined the Atlanta Bank Board, it was $30 billion in assets and $13 billion in advances. It's now $116 billion in assets and $85 billion respectively.

Perhaps more importantly, the level of financial sophistication and complexity associated with running the Bank has increased at an even greater pace. These trends have profound implications for governance at the Federal Home Loan Banks.

At the same time, we must remember that the Banks are organized as cooperatives. A structure I believe still best serves our members and the American public.

Mr. Chairman, the Bank System is critically important to my institution and the 8,000 other local institutions, as well as the communities we serve. I commend you and the other Directors for holding these hearings and taking responsibility seriously, as you begin to look at the governance of the Banks.

We in Atlanta hope this exercise is the beginning of an in-depth study and analysis of the Bank's governance and related issues. We strongly urge that the Finance Board 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 Bank's governance rules maintain and strengthen their statutory structure and their mission. Mr. Chairman, the course you have laid out can be a great step towards a very productive result.

With respect to Atlanta Bank's governance. We are very committed to cooperating with the Finance Board's process and we are also committed to implementing and maintaining the best practices regarding its governance.

Our commitment is based on a very simple premise: robust corporate governance is critical in 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 is markedly different from the typical corporate board structure.

The Federal Home Loan Bank Directors are elected and appointed in a manner that is dictated by statute and regulation. The statutory structure could be viewed as inconsistent with what is considered best practices for traditional corporations regarding Directors' independence.

The appointed Directors are such an example. While independent of Bank's management, these appointed members do not meet the definition of independence applicable to public companies. They are appointed by the Bank's regulator.

While the composition and structure of the Federal Home Loan Bank Boards may be perceived to be in conflict with traditional corporate governance standards, the structure has worked very well over 70 years. A dynamic relationship between the industry and the Public Interest Directors has contributed to the achievement of the Bank's public mission.

Changes should be considered, but only cautiously and with full analysis of the potential consequences. The Atlanta Bank Board 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. To help ensure that our Board and management continually review the governance practices, we established a new governance committee, which is charged with educating, advising, and assisting the Board in the development and implementation of the best practice with respect to governance.

Issues for considerations: There are a number of issues regarding the Bank's corporate governance that we believe warrant additional consideration. There are also many factors that go into producing the most effective Federal Home Loan Bank Director. Initially and ideally, such a Board is 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 a 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. Obtaining such knowledge requires time and hands-on experience at the Bank.

I'm sure you recognize that developing standards and rules to achieve the most effective corporate governance will require balance and managed expectations.

With respect to Director qualifications, clearly, the more financial and housing-related experience a Director has when he or she is elected or appointed, the better position that Director will be in to make an immediate contribution.

As the Banks engage in more complex financial activities, it is equally clear that specific types of expertise can be of great benefit.

Mr. Chairman, the Finance Board recognized this when it published the proposed rules requiring at least one Public Interest Director have a background that demonstrates, "an understanding of the risks faced by a particular Bank because of its investment financial activities."

Atlanta Bank supports the appointment of Directors that, in addition to their other qualifications have a background or expertise that will strengthen the Board's ability to analyze and manage risks.

Areas such as interest rate risk, market risk, and the risk arising from options associated with the Bank's financing and investment activities must be addressed at the Board level.

In fact, we believe all Directors should understand the Bank's business activities and the risk associated with these activities.

While the elected industry Directors have a solid foundation 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 also need regular educational opportunities beyond the initial orientation session.

With Director financial conflicts standards, Chairman Korsmo, you correctly noted in your opening comments that the financial world looks profoundly different than it did seven decades ago.

As I stated earlier, it is profoundly different than it did seven years ago. As the programs and operations

of the Banks have continued to evolve, the need for greater financial and housing-related expertise has grown, as well.

The Atlanta Bank recommends that the Finance Board adjust its regulations to permit otherwise qualified persons to place stock or other financial interests in any member of a Federal into a blind trust with the purpose of meeting the statutory requirements. Many of the most qualified individuals with the greatest financial expertise have experience in the financial services industry or dealings with that industry.

As a result those persons most qualified to understand the Bank's business activity may have an interest in a financial institution that's a member of the Federal Home Loan Bank. The quality of governance by the Banks' Director should be enhanced by permitting qualified persons to place their prohibited financial interests into a blind trust.

Given the short term of office applicable to a Federal Home Loan Bank Director, as well as the nominal fee paid, the requirement for divestiture of prohibited financial interests, may discourage otherwise qualified individuals from serving.

In concern of the area of Director compensation, Congress has already begun to look at this issue know, it's

part of the Finance Services Regulatory Relief Act of 2003. As they have highlighted the responsibilities and obligations of Federal Home Loan Bank Director far exceed what they once were.

Because the oversight of each Bank is vested in its Board of Directors, it's reasonable to consider whether the compensation of those Directors should be flexible enough to be commensurate with that responsibility in time and commitment.

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

The Financial Board should determine, in addition to defining Director qualifications, how much time a Director should be expected to spend on Federal Home Loan Bank duties. This will help build a rationale for adjustments of compensation.

With respect to Director terms, one of the challenges the Banks faces is the time required during Board meetings to orient and educate newer Directors.

When the Board of Directors meet their agendas are extensive and the time allotted to each issue is precious. While this is, in part, the nature of the business, changes

that can lessen the need for many orientations will allow greater energy to be devoted to governance.

The Financial Services Regulatory Relief Act, mentioned earlier, contains another provision that may help in this regard. It would extend the terms of elected and appointed Directors from three to four years.

Over the past several years, there's been a natural turnover of Directors. Since 2002, 16 of our 18 Board members have been elected or appointed to their very first term. This means that we currently have two Directors with more than two years experience on our Board.

As the Finance Board study reported, Directors state it takes 6 to 24 months to understand the operations of the Bank. Longer terms could bring continuity and experience.

With respect to industry Director elections, Sommer raised the issues whether the current election process for industry Directors should be reviewed. The current allocation of voting rights ensures that smaller members have a voice. Those have raised a question about the process suggesting 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 large amounts of stock. And, as a result, may lose some of their voting rights.

This is an issue that may be worthy of further discussion and review, in our opinion. Further, 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 Bank's cooperative structure.

With respect to 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 Boards of Directors to engage in sound governance. Through the selection of the most interested and qualified candidates, the Finance Board can ensure a sound knowledge base exists. Through the appointment of new Directors, it can ensure that the new ideas, as well as refreshed scrutiny are brought to the table.

And through selective reappointments, the Finance Board can ensure the degree of continuity in institutional knowledge is maintained.

The Atlanta Bank believes that each Bank should be able to provide valuable guidance and recommendations to the Finance Board in their search for qualified Public Interest

Directors. Currently, there is no opportunity for this dialogue to take place and we ask that you consider a way to facilitate it in the future.

In conclusion, although we believe that the Federal Home Loan Banks unique structure dictates certain corporate governance rules that are quite 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 the burden is greater than ever before at the Bank level and for you at the Finance Board to ensure that the governance at the Banks can be achieved at the highest level.

In considering any changes or enhancements to the Banks governance practice, 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 generic governance mode, then we community bankers who rely on this System may suffer, as well as our communities may suffer.

Mr. Chairman, you've said on many occasions that you, as a regulator are not our cheerleader or our advocate.

I could not agree with you more. As a regulator, you are charged with ensuring that the Banks operate in a safe and sound manner. Part of the responsibility includes ensuring that the Banks are not prevented from operating in a manner that allows it to meet their corporate and public statutory missions.

We appreciate your efforts to date. I commit, on behalf of the Atlanta Bank Board to continue to strive for the highest standards of corporate governance. And as this process moves forward, the Atlanta Bank will continue to review the issues related to governance and will be pleased to provide further responses to any questions that the Finance Board may have. Thank you, Mr. Chairman.

CHAIRMAN KORSMO: Thank you, Mike. You and your predecessor, as chair of the Federal Home Loan Bank of Atlanta, Ed Norris have both been very helpful in this process and we appreciate it.

I was toying with whether we'd have the management guy--

MR. JETTER: I'd be happy to go last if you want--

CHAIRMAN KORSMO: --give the last word; whether we have him go first, so that they'd have a chance to beat him up, the Board members, throughout the process. So we compromised, we had him dead center. So, you've gotten the

chance to hear the two Mikes, but Rick and Bob will still have an opportunity to correct you when you're done.

MR. JETTER: That's fine.

CHAIRMAN KORSMO: And so, with that, Andy Jetter.

MR. JETTER: Appreciate that -- Chairman Korsmo, Members of the Board, thank you for the opportunity to testify today at this hearing on corporate governance.

I strongly support the Finance Board's focus on this important and timely topic. Although I vetted my testimony with members of my Board of Directors, the statements I make today and the positions I espouse are mine and are not intended to be a statement of any official position of the Topeka Bank or its Board of Directors.

In general, I believe the corporate governance practices at the Topeka Bank are very strong. We welcome the Finance Board's horizontal review of our governance practices and we subsequently embrace many of the best practice recommendations made in the final report.

However, there is one area that I believe needs further evaluation: The Director election and appointment process. While we continue to evaluate and implement improvements in corporate governance practices that we exercise some control over, we recognize that changes in the election appointment process for Directors

can only be made by Congress with respect to statutory provisions and by the Finance Board with respect to regulatory provisions and appointment practices.

Before addressing my recommendations on approving the Director and election appointment process, I want to comment, generally, on the broader question of the best approach to evaluating and developing recommendations for improvement in the corporate government practices at the Federal Home Loan Banks.

It may be more fruitful for the Federal Home Loan Banks to create a task force composed of Directors and management that would undertake a comprehensive study of governance practices. Such a group would need adequate time to complete its work and provide formal report of its conclusions.

Its report would be informative for the Finance Board in evaluating its regulations and practices; for members of Congress, as they evaluate possible statutory changes affecting corporate governance; and for the Federal Home Loan Banks themselves, as we each strive to improve our own governance practices.

I intend to explore this proposal with the other Federal Home Loan Banks to determine the level of interest in proceeding with such an endeavor.

Underpinning the recommendations I will make today is the belief that the governance practices that the Federal Home Loan Banks should mirror the best practices employed in public corporations generally, subject only to such modifications that are necessary and appropriate because of the unique structure of the Federal Home Loan Banks. Adoption of these practices should be strongly encouraged.

I'd like to address three areas with respect to the selection of Directors. First, the Director appointment process; second, the Director election process; and, finally, my recommendations for how these processes can be improved.

But before I do that, let's discuss briefly the overall objective in selecting particular individuals to serve on a Board. Regardless of whether we are appointing or electing Directors, the basic objective is the same: it is critical that members of a Board of Directors possess the appropriate skills, education, and experience to perform their duties.

I am not suggesting that every Director must possess identical skills, education, and experience, as it is vitally important to have a diverse -- to have diverse interests and backgrounds represented on a Board of Directors of a Federal Home Loan Bank. However, Federal

Home Loan Banks are large, complex business organizations that require a combination of Directors that jointly have the knowledge to understand the Bank -- both in terms of its operations, as well as the management of the risks those operations create.

It is imperative that a Federal Home Loan Bank's Board be composed of both elected and appointed Directors that can understand and provide meaningful oversight of the operations of that Federal Home Loan Bank.

With respect to the current appointment process, I see several weaknesses that need to be addressed. I acknowledge that there does seem to be an objective to promote diversity in terms of the individuals appointed, which I wholeheartedly endorse as essential to good corporate governance. However, more emphasis should be placed on how the specific experience and skill sets of a potential Director would complement those that already exist on the Federal Home Loan Banks Board.

The appointed Directors with whom I am familiar are individuals of good character and successful in their chosen careers and bring value to the deliberations of the Board. And each is individually qualified to serve as a Director. However, I have not sensed that significant focus is given to identifying individuals with specific skill sets

needed on the Board to complement the skill sets of our other Directors.

Clearly, good corporate governance practices strongly suggest that the objective is to build a Board of individuals that have a variety of skills, but that collectively possess all the skills necessary to provide effective oversight of the Bank.

I find especially troubling the apparent policy against reappointment of current Directors. Although I understand some exceptions are being granted for individuals originally appointed to fill less than a full three-year term.

In an organization as complex as a Federal Home Loan Bank, this bias against reappointments results in a loss of experience and knowledge gained through prior service as a Director. Both the selection process for appointing Directors and the barriers to reappointment should be reconsidered.

An even more significant concern with the current appointment process is a problem that can only be fully remedied by Congress. I appreciate the Finance Board's endorsement of the importance of being an independent regulator and observing a bright red line between the regulator in the regulated institution. But the current

situation, in which the regulator appoints Directors to the Board of the regulated institution, is completely inconsistent with this concept.

The selection of Directors by the Finance Board represents a clear violation of the independence objective and creates a unhealthy situation where the regulator has a major role in the management of the regulated institution.

The ultimate resolution to this issue is to amend the Federal Home Loan Act to remove Finance Board responsibility for the appointment of the Directors of a Federal Home Loan Bank.

An alternative, sometimes suggested, but which would be just as inappropriate would be to have the President of the United States make these appointments directly as is done with the other Housing GSEs. An interesting development, according to recent news reports, is that the President has decided to not reappoint directors to Freddie Mac's Board when the existing terms of appointed directors expire, apparently to eliminate a similar conflict.

Bottom line, the United States government should not be in the business of appointing directors to non-governmental corporations, even if those corporations are government-sponsored enterprises.

Appointed Directors provide significant strength to the overall governance of the -- of a Federal Home Loan Bank. I am not suggesting in any way the elimination of Directors completely independent of management and member stockholders. But the selection of those Directors should be done in a manner similar to public corporations, where they are nominated by Boards of Directors and then stand for election by stockholders.

This process would retain the vital role these Directors play, while ending the inherent conflicts in the current appointment process.

Now, let's turn to the process of electing Directors. It is clear that the current voting rule set forth in the Federal Home Loan Bank Act, have the effect of increasing the control of smaller member stockholders in the voting process, relative to larger members who own a majority of the outstanding shares of a Federal Home Loan Bank stock.

These provisions significantly reduce the likelihood of representatives of major stockholders serving as Directors of a Federal Home Loan Bank. Thus, depriving its Board of Directors of the unique experience such individuals often possess.

Don't misunderstand what I'm saying: executives of smaller member institutions are fully qualified to serve as Directors of a Federal Home Loan Bank and not having any Directors representing this major constituency would be a mistake.

With that being said, additional consideration should be given as part of the election process, to the identification of the specific skill sets, experience, and education needed in order to build the most qualified Board of Directors possible.

Currently, the Finance Board prohibits, by regulation, the involvement of the Board of Directors and the management of a Federal Home Loan Bank in the election process. That regulation, 12 C.F.R § 915.9 reads in part, "No director or officer, attorney, employee, or agent of a Federal Home Loan Bank may communicate in any matter that a director or officer, attorney, employee, or agent of the Bank directly or indirectly supports the nomination or election of a particular individual for an elective office or take any other action to influence votes for a directorship."

The effect of this regulation is to prevent the Board of Directors of a Federal Home Loan Bank from fulfilling its proper role in seeking the election of

individuals whose particular skill sets would best complement those of other Directors and does not reflect current thinking on best corporate governance practices.

Finally, let me provide specific recommendations on how to improve the Director election/employment process.

With respect to both appointed and elected Director positions, current Directors and management need to be actively involved in the selection process. Boards and management should work cooperatively to identify needed skill sets that would enhance the performance of the Board; identify individuals that possess such skill sets and then recommend those individuals for appointment or election.

At first glance, the recommendation to include management in the process seems to fly in the face of current trends in corporate governance that focus on ensuring that there's independent oversight of corporations--

CHAIRMAN KORSMO: That's one question, I don't have to ask.

MR. JETTER: -- sufficient to prevent the problems associated with entrenched management. The ultimate responsibility for an organization lies with its Board of Directors. How, then, can giving management, along with

Boards, a larger role in the selection of Directors be consistent with good governance practices?

To understand why this position is consistent with best corporate governance practices, one must recognize where governance practices have been and where they are headed.

The problem that exists in large corporations with thousands of shareholders is that management can, indeed, become entrenched. By nominating for open Board positions only those individuals with close ties to the CEO, a board of individuals loyal to the CEO is formed.

The most effective approach to reduce or eliminate this risk is to require that a majority of the Directors serving on the Board be independent of management and to encourage independent Directors to take a greater role in the nomination process.

In other words, on the continuum of corporate governance practices with one end at which practical control and influence lies completely with the CEO and at the other, at which practical control and influence lies completely with Directors independent of management, current governance recommendations suggest that corporations need to move away from complete CEO dominance. Such that outside directors are given significant responsibility and influence.

But I am not aware of any best practice recommendation that would support moving to the other end of the continuum where outside directors have complete control and the CEO has little or no influence.

In the case of director selection completely excluding management from the selection process is simply not representative of best governance practices.

The challenge we have in applying best corporate practices to a Federal Home Loan Bank, is that Federal Home Loan Bank Boards have no management representation. However, virtually all research on governance practices assumes that management is, at a minimum, represented on the Board and, typically, the CEO of the organization also serves as chairman of the Board.

Let me be clear: I'm not suggesting that management should serve on the Board of Directors, however, management should actively assist the Board in the identification of individuals to recommend for election and appointment as Directors.

In conclusion, the Finance Board has the ability to immediately and significantly enhance the corporate governance practices of the Federal Home Loan Banks by taking the following steps:

One, rescind 12 C.F.R § 915.9 that prohibits the involvement of Boards and management in the election of Directors; and encourage Boards and management to become actively involved in identifying qualified individuals to serve as Directors and recommending the election of those individuals to the Federal Home Loan Banks' stockholders.

With respect to appointed Directors: Place the responsibility on each Board -- Bank's Board of Directors with management assistance for determining the desired skills needed on the Board and for identifying individuals who possess those skill sets. Provided that the recommended individuals meet appropriate guidelines, the Finance Board should appoint those individuals as Directors.

In essence, the Finance Board would be devolving this critical corporate governance function to the Boards of Directors where it more properly belongs.

I believe the Administration, given its recent position on the appointment of directors for Freddie Mac, would support this change in practice.

And, finally, support legislation that would devolve to the stockholders the authority to select independent Directors.

These changes would place responsibility for the governance of a Federal Home Loan Bank where it properly

belongs: with the Board of Directors and stockholders of that Bank. However, if the Finance Board chooses to not adopt these recommendations, I urge that it least consider the following changes: Make the appointment process more open so the selection process is fully understood. Solicit input from the Federal Home Loan Bank Boards and management on the particular skill sets that would be beneficial in appointed Directors, end the bias against the re-appointment of Directors; and complete the appointment process no later than December 31st each year.

In summary: My recommendations can be boiled down to a few sentences. The process of selecting qualified Directors is a critical component of good corporate governance. Best corporate governance practices clearly place that responsibility with an organization's board of directors and management. The Finance Board should take appropriate steps to permit the Federal Home Loan Banks to implement this best practice.

Thank you for the opportunity to address this important topic and I'd be pleased to answer any questions you have.

CHAIRMAN KORSMO: Thank you Mr. Jetter.
Mr. Mroz.

MR. MROZ: Mr. Chairman, Members of the Finance Board, I am Richard Mroz, an appointed member of the Board of Directors of the Home Loan Bank of New York and chairman of our Bank's external affairs committee.

I appreciate the opportunity, on behalf of the Bank to provide testimony to the Finance Board in connection with the Finance Board's second public hearing on these issues pertaining to corporate governance.

I hope this hearing proves as productive as the first in January. And I've had the opportunity to review the testimony of the many groups that did testify.

The mere fact that virtually every housing-and lending-related industry group testified underscores the importance of the corporate governance of the Bank System, as well as the importance of the Home Loan Bank System to the housing and community development industries.

The Federal Home Loan Bank of New York, commends the many actions taken by the Finance Board and Chairman Korsmo to change the way the Federal Housing Finance Board oversees the Home Loan Banks and the Office of Finance. In particular, the Federal Home Loan Bank of New York acknowledges that the Federal Finance Board no longer acts as the backseat-driver at the Banks, but, rather, serves as the arm's-length regulator.

The Federal Home Loan Bank of New York also applauds the Finance Board for making corporate governance practices an area of focus and study. We agree with the Finance Board's attention to governance is well placed, especially in light of Congress's continuing focus on the regulation of the housing GSEs. It makes sense that the Finance Board should be prepared to identify these potential changes to laws or regulations that might help the Bank Directors better fulfill their obligations and responsibilities.

The Federal Home Loan Bank of New York wishes to note for the record that governance has been a topic of concern for the Finance Board for some time, as evidenced by the Office of Supervision's Horizontal Review, which was conducted in 2003.

As a Director of the New York Bank, I was pleased to be a participant in that survey. But I'm also personally delighted in the product. During our Board's discussions on various issues, I would ask for comparative information as to how the other 11 Banks were undertaking a certain matter. Or to seek information on comparable policies or procedures that we were evaluating. On many occasions, the response that I received was incomplete or was only anecdotal in terms of the comparative analysis that was provided to us at

the Board. Therefore, the horizontal review is certainly a very good product. It will help standardize the governance practices, where appropriate, in the 12 regionally owned and directed Home Loan Banks.

The Federal Home Loan Bank of New York also recognizes that there is no current governance proposal on the table, nor has a consensus been reached on any proposal. We will certainly have more to say when a proposal's formally presented for consideration. That being said, we, at the Bank, are eager to participate in a System wide discussions and dialogue, potentially leading to the development of these strategies intended to help the Boards and the Banks better identify, measure and monitor, and control risk.

Here, we would like to stress that, while the Bank System may be a GSE -- a government-sponsored enterprise -- it is also a cooperative owned by the over 8,000 community lending institutions. Needless to say, these owners need to be heard from and their views thoroughly considered before any corporate governance proposal is drafted. As such, we support the Finance Board in its current efforts to solicit public input on these critical matters of governance.

The Federal Home Loan Bank of New York believes, as an initial premise, following and to the extent possible

the various requirements and standards established under Sarbanes-Oxley with respect to the Boards, the Board committees and codes of ethics is a good place to start when it comes to establishing these principles of governance.

And there's much more to discuss in the weeks ahead. In the testimony in January, the two Home Loan Banks who presented testimony, in Boston and Des Moines, supported the elimination of the statutorily imposed Director compensation cap. And you've heard my colleagues discuss that today. I note that both of the other Banks, Des Moines and Boston, discussed the potential future problems of recruitment; retention of highest quality Directors when compensation is significantly below that of other comparable Directors' organizations and has been pointed out also by my colleagues.

Therefore, it does seem worthwhile that the Finance Board consider working with Congress to increase or possibly eliminate the cap.

Both Boston and Des Moines called for the Housing Finance Board to favorably consider reappointments when warranted. And my colleagues have also addressed that today. Certainly, the Banks are complex organizations, the Directors who have met their fiduciary responsibilities have current insight into the organization of a particular Bank

and have met the duties of a Public Interest Director should be strongly reconsidered for reappointment. I believe the Finance Board understands these arguments.

The evaluation of the proposals and ideas that are being discussed today and put on the table in January, are certainly of no easy task. Indeed, the Finance Board has many points of view to consider.

To illustrate this observation, I point to somewhat conflicting views taken by the Des Moines and Boston Banks on the question of having financial management expertise as being part of a criteria for at least one appointed Director.

The Des Moines Bank supports the idea, pointing out that the Home Loan Banks are complicated large institutions and are necessarily involved in complicated transactions. You've heard these arguments again today. However the Boston Bank notes that this well-intentioned proposal, but it could have, I think, the unintended consequence of encouraging Directors to defer to a designated Director and would discourage them from using their own independent judgment.

While the New York Bank has not taken a particular stance on this specific matter of having expertise as a criterion, I would like to express my personal view. As an

appointed Director beginning a third year on the Bank Board, I know from first-hand experience, that initially, this learning curve is steep, but not insurmountable. however, I must comment, that many of my fellow Directors on the Bank Boards, even industry-elected Directors, many with long careers in banking find the career -- learning curve, as well, to be steep.

My experience as a former public official, now as a lawyer advising corporate and institutional clients, leads me to conclude that if board governance is vibrant, when Board members bring diverse careers, disciplines and experiences. I am not sure that adding a hard-and-fast criterion for Director selection is ultimately productive. To me, a far more important requirement is selecting Directors who would bring to the board table broad-based and proven management experience. And, as Ms. Condit used the term this morning, I think, having functional understanding of the operations.

That concludes my testimony to the Finance Board. We look forward to working with you. We'll roll up our sleeves to work with you and continue the dialogue to promote better governance for the Banks.

CHAIRMAN KORSMO: Rick, thank you. Always tough to bad cleanup, but we got the right man for the job, Bob Barone.

MR. BARONE: Thank you Mr. Chairman, Mr. Secretary, and Directors.

I have sat on the San Francisco's Board since sometime in 1996, so looking at the fact that today is 2004, it seems like yesterday. And it was, I think, proper that you put me last because, as our reputation has it, we don't quite think -- we think that there are other aspects that the Finance Board should consider in governance besides what my colleagues talked about.

To be sure, I do agree with -- we do agree with most of what they said about Director qualifications, terms, and compensation. And you'll see that in my remarks.

But we have two other issues that we think are of grave importance to the System and that is member rights and joint and several liability. I'm not going to read the remarks that were prepared. I assume they will be in the record. I'm going to kind of complement those remarks and you'll see as I go along, give you a flavor for how we came up with our decisions. Let me first start talking about member rights.

The San Francisco Bank believes that the members should be permitted to vote on corporate matters other than Director elections. Especially on issues of significance, for example, the capital plans. These rights should be similar to the rights afforded shareholders of corporations or cooperatives.

While the Finance Board has ruled that all of these powers reside in the Board of Directors, some of our members question whether such a legal interpretation is correct. Whether the Finance Board has the power to change this or it must be done by the Congress, the San Francisco Bank believes this is an issue that should be at the top of the governance agenda.

I'll talk briefly about Director qualifications, terms, and compensation. This is an area that we believe is within the purview of the Finance Board.

At the Chair/Vice Chair meeting held in December, nearly every Bank indicated that both Director turnover and qualifications were issues. And you've heard that today from my colleagues.

The turnover issue appears to be partly related to the political cycle for the appointed Directors and partly related to the expanding base of smaller and more-diverse

member institutions and to the contraction of the larger institutions due to mergers for the elected Directors.

The Finance Board can partially solve this issue by asking Congress to lengthen Director terms; we suggest from three to four years. The question of term limits remains and the San Francisco Board discussed both two-year term limits, that would be eight years--I'm sorry two-term limits that would be eight years and three-term limits that would be 12 years.

Also, the method of appointing Directors should be discussed, perhaps there is room for input by each Bank's Board of Directors and my colleagues have brought that out clearly.

The question of Director qualifications is yet another issue. While keeping diversity as a top priority, the Board of the San Francisco Bank believes that there should be high standards set to ensure that the Directors can understand the increasingly complex issues that we face. This doesn't mean that every Director has to have an MBA, but it does mean they have to have both the business acuity and the interest to serve.

For the past few years, the San Francisco Bank has run introductory seminars for new Directors and seminars for

all Directors on new issues; several seminars, for example, on FAS 133, which we still don't understand.

The Board of the San Francisco Bank applauds the efforts of the Finance Board to offer such workshops to the Directorates of all the 12 banks.

The issue of Director compensation goes hand-in-hand with that of Director qualifications. Let's face it, the compensation levels fixed in the 1999 law are woefully inadequate, especially given the increased responsibilities and the complexities of the issues that face the System. If we're going to demand higher standards of our new Directors, then it is our responsibility to compensate them fairly. Good governance demands that compensation be devolved to the Banks' Board of Directors themselves, with oversight by the regulator.

Now, let me speak briefly about joint and several liability. And I noted this morning that Director Mendelowitz asked several questions about it.

The System is unique in that the 12 Banks share joint and several liability for all of the issued debt. Yet, in reality, very little information is exchanged between the Banks. The Directors of the San Francisco Bank believe that, for the sake of safety and soundness, information sharing between the Banks should be enhanced and

should go well beyond even SEC-type disclosures. Even to the extent of sharing exam reports.

Such a regime of information can only be administered by the Finance Board.

Thank you for allowing me to testify and I would be glad to answer any questions.

CHAIRMAN KORSMO: Thank you, Bob. Let me--let me take a crack at the first one.

It's been interesting to hear the conversation because, certainly, while there have been -- each of the five of you has presented something of a different focus or something of a different emphasis. I think there has been kind of a common thread that has gone through all of the testimony, whether it's an initiative and referral option or something different and each of you, in one context or another, have come up with something.

The common thread, however, is that there may be a need to get away from the existing statutory and regulatory frame work that assumes that one-size-fits-all. Quite clearly, there are very different business plans that exist among the 12 Banks. There's very different mission focuses at the various -- among the 12 Banks. There are very different balance sheets among the 12 Banks. Is part of the problem, and I'll certainly open the conversation for anyone

who wants to respond to it -- the fact that each of you is required or each of the 12 Banks is required to fit your corporate governance model into one mold, without the opportunity -- again, under current statute and to some extent -- well, not to some extent--and, also under our regulatory frame work -- you're required to have the same kind of pattern. The only place where it varies, I already alluded to it is that there is the minimal 14-membership -- 14 member requirement of the Banks in every case with the exception of yours, your Bank, it's larger.

I thought it was interesting that we heard the comment -- the suggestion that 11 is probably as many as can effectively take on this function. Although there would certainly be people who would disagree with that assessment, but it was certainly an interesting perspective to bring to all of this.

So, my question is: Is it time to get away from one-size-fits-all and, perhaps, have the regulator’s involvement, if you will, be limited to an annual assessment by the Office of Supervision as part of the exam process that the Board is operating effectively and that the structure it has set for itself is appropriate?

MR. JETTER: Can we just vote yes or no, or? [Laughter.] I would say, I'd be happy to go first. I think

that would be very consistent with the testimony I think you've heard this morning. That corporate governance of the structure of a board, the Directors you have on their board, their skill sets is something that needs to be really tailored to that organization. And it's something that's at the core of good management good corporate governance, the Banks, themselves, should really have the ability to tailor what they do to their organization and then that should be something that the examiners look at when they come in to see how well that board is functioning; how well is the selection process carried out; what's the strength of that board.

Those would be -- the strength of a board would be something very standard that you would see looked that in other corporations, because it's so critical to --

CHAIRMAN KORSMO: No matter how the elected Directors are elected?

MR. JETTER: No, matter, right.

CHAIRMAN KORSMO: No matter how the appointed Directors are appointed? No matter how many of them there are; no matter what the level of compensation is? You're either going to be a doing an effective job of running the organization or you're not. Does that --

MR. JETTER: Well, I don't know if it's necessarily completely black and white, you're either doing well or you're not doing well.

CHAIRMAN KORSMO: It's obviously not that black and white.

MR. JETTER: Yeah, but incrementally doing better, you can improve that oversight role by --

CHAIRMAN KORSMO: There should be an ability on the part of the supervisory function -- the examination function to make an assessment of that --

MR. JETTER: Absolutely.

CHAIRMAN KORSMO: -- absent the peculiar limitations that are placed on the structure of the organization and membership of a board by statute or regulation.

MR. JETTER: But, presumably -- and I'll be quiet. Presumably the assumption making that assessment is that you're assessing the board and management in terms of what they have some capacity and exercise control over, which, today, is minimal, at best and, actually, prohibited with respect to elected Directors.

CHAIRMAN KORSMO: Well, that's interesting, because I think it was you, Andy, that or Mike brought up the 915.9 point. I got an interesting e-mail the other day

from a newly elected Director at a Bank that shall remain nameless. Let me just read it to you: Ethics and independence for existing Federal Home Loan Bank Directors and the election process, a personal opinion. He quotes, the personal opinion becomes a violation of the spirit of 12 C.F.R. § 915.9. As a newly elected Director who overcame the published opinions of two existing Federal Home Loan Bank Board members, it seems to me that some current Board members cross a fine line between independent opinion in attempting to influence an election by leveraging their roles as Federal Home Loan Bank Directors, perhaps some education -- So, the point being that whatever issue, there seems to be more than one point of view. And, maybe, if we got out of that process to the extent necessary and devolved the responsibility onto the Boards and made it clear that that was what was going on, I'm thinking -- I'm doing what we call "pulling a Mendelowitz" here. I'm thinking out loud rather than making a proposal.

But, perhaps, that goes to the whole question of devolution and why it might be important. Mike Radway.

MR. RADWAY: Mr. Chairman, it's interesting, the statute actually is a little bit internally inconsistent and I know that's hard to believe. But at one level, there is a prohibition on getting involved in Director elections. And

at another level, when an elected Director leaves in the middle of a term, it is the Board that selects their replacement without any guidelines in terms of what they do. They can totally ignore the desires or preferences of the shareholders from that particular state, so there's ennui.

I think the issue, though, getting to your original question, is not so much of a question of whether it's too much one-size-fits-all, but that in some areas we have complete flexibility and in other areas we have no flexibility. We have complete flexibility in terms of how we structure the operations of our Board, how we select our management, how management is structured. In those areas, we have a wide degree of flexibility. But what we don't have any flexibility on at all is the initial input of who sits on our Board, which is obviously significant. And, you know, there's the old expression about, garbage-in/garbage-out. Filet mignon in and you feel like you'll have pretty good hamburger out. And so, that's not an insignificant set of issues. We -- to a certain extent we have to work with whatever the Directors who are elected or who are appointed, but once you have that, we are now free to choose our own chair and vice-chair and organize ourselves in anyway we see fit. And there are some variations amongst the Banks in that area.

CHAIRMAN KORSMO: Mike?

MR. MIDDLETON: I think Andy has -- and Mike have pointed out very well the merits. And I think this reflects best practices in the industry. You know we recog -- at my Bank not the Atlanta Bank, at my Bank, that is a protocol we follow -- what do we need; what are our skill sets; what are our representations needed. And I think that's, as well, as a conflict for the appointed. Because I was appointed to replace an industry Director that was merged out of existence. And I think they made a good choice, but -- I had no input on it, it was, hello, you're in now. So, my luck of the draw.

But, I think it would follow best practices in the industry and this is just speaking as a member, not as the chair of --

CHAIRMAN KORSMO: Before I give Rick and Bob and chance to come in on it, too. Let me go to the point you made.

So there are only two of the 18 members of the Atlanta Board now that have, what did you say, more than two years of experience? And you're one of them, obviously, and I assume the other is another elected Director. Which means that even eight of the 10 elected Directors have turned over. Now, is that a product of the current term limitation

that's in the statute with the limits elected Directors to three-year terms? Or is it just a -- just a --

DIRECTOR MENDELOWITZ: Fluke.

CHAIRMAN KORSMO: -- fluke, thank you.

DIRECTOR MENDELOWITZ: Thinking out loud.

CHAIRMAN KORSMO: Or is it a fluke? Is it just a fluke of the electoral process that is people have either chosen not to run again or have been turned out?

MR. MIDDLETON: My term ends in '04. The gentleman --

CHAIRMAN KORSMO: Then you'll be term limited?

MR. MIDDLETON: I'm termed out. Ed Norris is termed out. And we had the corporate memory. One of our industry directors is terming out -- I don't know if he's terming out--I know he's been merged and he may leave the Board before 12/31, but this is a very serious problem.

CHAIRMAN KORSMO: So, with the other eight, though, are you--do you know were they termed out in most cases or was it some other factor that turned them over and--

MR. MIDDLETON: I don't think -- I don't know if I could comment because I would have to speculate.

CHAIRMAN KORSMO: Okay.

MR. MIDDLETON: But the point is that the terms are -- term limitation is creating a problem at a very inopportune time.

CHAIRMAN KORSMO: Right. Bob?

MR. BARONE: As I said in my remarks we believe that the turnover in the elected Directors is because the membership base is changing.

CHAIRMAN KORSMO: Yeah.

MR. BARONE: In San Francisco, all of a sudden the commercial banks now outnumber the old S&Ls, in terms of voting power. And then, also, we've had several Directors leave because their institutions got merged. And either were no longer eligible or got fired, I guess, from their positions.

So, that's with the -- I think that's why the turnover is rapid with the elected Directors. With the appointed Directors, it appears to be a political cycle. The Clinton appointees are, you know, at the end of 2000, he appointed several to our Board -- reappointed several to our Board and, you know, they seem to have all now been replaced by this -- by your selections here. So, it could be that over the -- if Bush is reelected, could be that the current appointed Directors stabilize. We'll see.

CHAIRMAN KORSMO: There was a reference earlier, though, to the point about the Administration's public statement that it will not be reappointing -- will not be appointing new -- naming new nominees to the Board of Freddie Mac and I think that Fannie Mae, one of -- their issues is in July, I think, when, is it May, when that issue will come up. I don't know, I don't have personal knowledge of what the Administration's thought process is along those lines, but it goes to the point earlier, again, about the idea being, maybe, it's time to devolve this process to those who are immediately affected by it, while somehow trying to preserve the focus on public interest that Peter Wallison, for example, alluded to earlier.

And so the only person who hasn't commented on my original question is Rick. I don't know if he had anything further --

MR. MROZ: No, I would agree with the proposition that each of these Banks -- it would by very productive to have them have a much larger say in it and maybe to devolve it to them. And I think from some of the comments you hear, each of the operations or even the industry within the district that the Bank represents is different. For instance, on the industry side, the changes have not been as dramatic for the old -- for the community bankers and,

therefore, they still are on the Board, there's longevity. But, obviously, in San Francisco it's a different story. So those dynamics are district-by-district and a proposition of having the Boards better manage and appoint, makes sense to recognize what's happening -- either in the industry or what the needs are -- from a public policy standpoint in that district.

CHAIRMAN KORSMO: I've taken too much time. Do any of my colleagues have questions? Dr. Mendelowitz.

DIRECTOR MENDELOWITZ: There is a bright red line that applies to my colleagues and myself on this Board that is more important than any other bright red line. It's the line between what we have power to do and what we don't have the power to do.

CHAIRMAN KORSMO: Right.

DIRECTOR MENDELOWITZ: What we can do is only those things permitted by the statute. The things we can't do are those things not permitted by the statute. And some of the issues you've raised are things within the purview of powers of my colleagues and I on this Board.

And for those things, we will think about very carefully because we only have two imperatives, I believe, as a Board, when we work on issues within our legal authority. And that is: We should try to do the right

thing. And we should try to do the right thing the right way. That's it. And if we do that, I think, you know, we can really contribute to improving things.

When it comes to things beyond our legal authority, it's a much different situation. Because the legislative process that changes things only takes place at large intervals of time. And when it does take place, all sorts of players get involved and you don't know what's going to come out.

Last year when new legislation started to be considered to change the regulator for -- originally just Freddie and Fannie, but now, all of us -- there was a paper circulating on the Hill -- a four-page-paper -- which represented somebody's wish list of statutory amendments to the authorities of Home Loan Banks.

Now that paper had no masthead on it. We don't know who it came from although there were credible ideas about where it came from. But I looked at those four pages of statutory proposals and my reaction was they would seriously inhibit the ability of the Home Loan Banks to function effectively to fulfill their missions.

And, so that means anytime you go for a statutory change, and it's not our responsibility to go up and lobby the Congress for a statutory change. I mean, that's

something, I believe the members and the Banks probably would do.

You have to think very, very carefully about how much of an impediment is the thing you want changed versus what are the risks that somebody else could get involved in the statutory process that would wind up actually leaving you in a worse position than you are now. And I just put that on the table as something to consider. Because when the issue, for example, of Director compensation comes up, my reaction is, first of all, how poorly paid are Directors? Well, on an hourly basis, if you -- a Director puts in the number of hours that Ms. Condit thought was the minimum you have to put in, the Directors would be paid on an annual basis of twice the rate of my colleagues and myself sitting around this table.

And, were a Director to put in 250 hours a year, they would be paid on the hourly basis at the same rate that my colleagues and I are paid. So, I'm -- one, I'm not sure that they're really underpaid. Although they may be, I mean, there's, you know, but it's something you have to look at.

Secondly, I'm a firm believer in supply and demand. And while I can't speak for the two lawyers on the Board, I'm willing to venture that I can speak for --

presume to speak for Commissioner and Weicher and myself. And that is, if you have a circumstance where there's excess supply, it means that the price is not set too low, the price is probably set too high. And when we went through the PID process, there were many, many candidates who wanted to be appointed as Public Interest Directors than there were positions available.

The last time I looked at an election, there were far more members willing to run for elected Director positions, than there were elected Director positions open. So, I would say that my colleague, Commissioner Weicher would describe that as a circumstance of excess supply. And in any circumstance of excess supply, one does not usually think that price is set too low. So, that's my implied question.

MR. BARONE: Yeah, the price is actually set, instead of the free market price being allowed to clear the market.

[Laughter.]

CHAIRMAN KORSMO: Then there are other -- there's the -- isn't there a -- I came up with moral hazard, but isn't there the fallacy of assuming there are no other factors? What is that, there's got to be a term for that?

[Laughter.]

DIRECTOR MENDELOWITZ: Anyway, this is all by way of saying, think carefully about what you want in the way of statutory changes, whether they're really worth both what it takes to get a statutory change and the risk that you get exposed to because you cannot control what the outcome is. And if somebody else who does not have your interests at heart and who do not have the mission of the Home Loan Banks at heart, manages to get statutory changes, the Banks could wind up in a far poorer position than they are in now.

Secondly, I wanted to say that I really appreciate your participation today and I read through all of your proposals. And marked them up and all. And what I really appreciated was you had lots of specific ideas -- some statutory, some regulatory. And I just wanted to assure you that we are going to give very, very careful attention to them. Because we're looking at how to do the right thing in the right way. And I think a number of your proposals will help us in that.

And, lastly, as a regulator, I do take comfort from both the dedication, commitment, and skills represented by the five panelists, Directors, President, Chairman. I take comfort from knowing that people of both your skill and commitment are involved in trying to assure the safety and

soundness mission of the System. And I appreciate that. Thank you.

CHAIRMAN KORSMO: Director Leichter.

DIRECTOR LEICHTER: Yes. I thank you for your testimony. I wish it had been given before we acted on the Public Interest Directors. I'm not sure it would have made much of a difference in the result, but I think the viewpoints you expressed which, by the way, was also expressed by the first panel we had. Certainly identifies Public Interest Directors as an area of great concern. I think as you said, Mike Middleton, there's probably nothing more important to do about governance than choosing Public Interest Directors.

And I conclude from the emphasis that you put on Public Interest Directors and how you expressed that there's a great deal of dissatisfaction at what the Board has done. And I think we have failed to help the governance of the Banks.

My own view is that the System in using Public Interest Directors is broken and I think it's become terribly politicized. It's true for previous Administration, also. I mean, it's ironic that the administration has said, and I think, in good faith and for good reason that they're not going to make recommendation

for directors on Freddie Mac and Fannie Mae, but the Administration's very actively involved in making recommendations for Public Interest Directors on the Federal Home Loan Banks. So I find a lot of interest in the suggestion that a number of you made that we might devolve this to the choosing of the Public Interest Directors to the Boards. And I have a question of how we could do it.

And I want to say, when I talk about how the process has been politicized, it's also, in a certain sense, tainted our own governance, because we don't act on this collectively or have any deliberation. The Chairman very candidly stated at the meeting where we chose the Public Interest Directors, he said, "Oh, I had an unusual--that was his word, unusual number of discussions with Commissioner Weicher and Director Castaneda." There were no discussions on the list that he recommended with Directors Mendelowitz and Leichter. That's certainly, if you want to talk about good governance, that's a very good example of bad governance. But, it seems to me that since the statute says that it's the Finance Board that makes the selection of Directors, I just wonder whether you feel the System -- and I'm going to pose to you would work that each of the -- that the Finance Board sets forth criteria that acting on those criteria, each of the Banks puts forth its recommendations

and the Finance Board, since we have the statutory authority, will then make that the final decision taking into account and I would hope with great deference to the recommendations that are made by the Board, do you see a System like that meeting some of the concerns and interests that you have in improving the governance of the Boards?

MR. BARONE: I do believe that if the Board's--in other words, your proposal would be that you submit to us a slate of potential candidates and we've discussed them or the other way around?

DIRECTOR LEICHTER: No, no, the other way about. We would set forth criteria --

MR. BARONE: Okay.

DIRECTOR LEICHTER: -- that you should use in making recommendations for Public Interest Directors.

MR. BARONE: And we would make recommendations to the Board?

DIRECTOR LEICHTER: You would then make recommendations. We would act on those recommendations and, as I said, hopefully, with the greatest deference to see whether in fact you've met the criteria that we have in mind and maybe taking a look at what you feel are the qualifications and the particular needs that your Boards have a that time. And then, since we have the authority,

which I don't think we can devolve upon you. We would then act upon your recommendations because the statute says it's the Finance Board that shall appoint the Directors. Do you feel such a System would work?

MR. BARONE: Yes, I do, you wouldn't have any qualms about us, if there's one opening only submitting one name, as long as they're qualified?

DIRECTOR LEICHTER: Well, I think these are all things, you know, for considerations or maybe we would say, submit two names for every position. I don't know, I'm just thinking a way of doing it, but it would seem to me that that would, one, still mean that we're complying with the statute, which obviously, we will. And, secondly, it will give us the insight into what your Boards need.

But thirdly, and most important, it would involve the Boards of the Banks much more directly and immediately in the selection of Public Interest Directors. And, hopefully, will end the politicization of this process. I'm not pointing fingers at anybody on it. It's something that's occurred over the years but it's something that we need to change.

MR. BARONE: I agree, I think that that's a nice way around the statute and to allow us to have input. And you don't really care how we do it, as long as we do it,

correct? If we hire a gal like Madeleine to help us find the right Directors, it's okay with you guys, right? Whatever method we use it's okay?

DIRECTOR LEICHTER: We'd have to flesh this out, but, yes, you have to meet with, under what I propose, not proposing, but I'm thinking out loud with all of you here is we would set forth the criteria and you would make recommendations and we would see whether the persons you recommended met the criteria and if they do, I would assume that we would approve your recommendation.

MR. JETTER: I would just say that that's consistent with the recommendation that I made in my testimony. And I guess I was urging in connection with Director Mendelowitz's comment about, you know, the statutory changes and the difficulties and risks that you take -- that to the extent that we could move the System towards what is really best practices in corporate governance as much a possible without that statutory change, is going to have a big role in determining whether you need a statutory change. The closer that we can get to -- get to good governance practices within the current statutory constraints would be very helpful. And I, personally, would be very supportive of the process that you mentioned.

MR. RADWAY: Mr. Chairman, I'm not a lawyer, although I used to play one on C-SPAN, so I won't opine on what is statutorily possible to go with the question that Director Mendelowitz posed. But I have found that lawyers tend to be very creative and that there are probably a range of solutions short of a clean, clear statutory change that could range anything from that which has been suggested to intermediate positions where something along the lines of what was done with the capital plans where you ask each individual Bank to come up with a process and submit it to you and you would approve the process by which we would submit one or more names to you.

Or it could work the other way around where you go through the process of selecting a series of names and vet those names with us and we are allowed to give you input as to which of those candidates fill the gaps that we have on our Boards. There are a variety of ways that that could be done short of an actual statutory change.

MR. MIDDLETON: May I answer your question with a question? The first question is would you incorporate, then, those issues that you have -- are in your purview with respect to a blind trust interpretation? And, secondly, is this something that would gain majority vote on the Board

here as, do you think that this is a workable option that we seem to be all concurring with on this end of the table?

DIRECTOR LEICHTER: I mean, this is something, you know, I threw out in a rough form -- I can’t speak to what the full extent of it would be, but I would urge my colleagues to give serious consideration to it, because I think it's the right direction to go and I think it responds to what are very legitimate concerns that you and the other panelists have expressed about the problems that we have with the PID process.

CHAIRMAN KORSMO: Let me respond to your specific comment, though, Mike. I mean part of the problem, of course, is that limitations on the holding of shares is a statutory limitation, it isn't part of our regs, it is in the Bank Act. And so, it's much more -- we'd need a lawyer of Mr. Mroz's quality and qualifications to figure out a way, probably, around that, if you will.

The other problem, of course, is, you know a blind trust, as such, really doesn't fit this model, because, obviously, the offending shares, if you will, are going to be the shares of Community Bank of Tri-County and so putting them into a trust doesn't really make it blind in any way. I still know that I have the shares of Community Bank of

Tri-County and so the blind element is difficult to contemplate. But it is an issue we've looked at.

MR. MIDDLETON: I apologize, I thought that was a regulatory interpretation --

CHAIRMAN KORSMO: No, no, unfortunately that's --

MR. MIDDLETON: I withdraw that portion of the question.

CHAIRMAN KORSMO: But that doesn't mean that there isn't a way to -- and that, you know, those are the kinds of ideas, frankly, that we're trying to look at and the suggestion that the current statutory limitation on that is problematic in gaining some of the expertise of the kinds we've all talked about is a real issue that we should have front and center.

MR. MIDDLETON: But I do support, with my colleagues, like I said, I think it's a very good idea--it's very good best practices, if you will, getting as close as you can to practice best practices.

CHAIRMAN KORSMO: Director Weicher.

DIRECTOR WEICHER: Thank you, Mr. Chairman. Just one comment to start with. My recollection of the last meeting, was, and certainly the fact of the situation was that Director Castaneda and I were calling you, that was the point that you were making?

CHAIRMAN KORSMO: That was the point I was trying to make.

DIRECTOR WEICHER: The --

CHAIRMAN KORSMO: I was hoping we could avoid some of the--

DIRECTOR WEICHER: -- which was certainly true. But -- I wanted -- I was thinking about what you all were saying with respect to the earlier testimony from Ms. Condit. It seemed to me that the burden of what you all were saying was not to reduce the number of Directors, talked about the need for balance for covering all these requirements needs for various abilities on the Board of Directors. Do you think 7 to 11 is a better number?

MR. JETTER: I just think that would be something that a Board would want to consider and have a discussion at Board management about what -- depend on how you construct the membership of that Board and the committee structures and what would be a number that would be most effective could be tailored to that institution.

CHAIRMAN KORSMO: Andy, you have what, 18 or --

MR. JETTER: No, we're at 15 right now.

CHAIRMAN KORSMO: -- 15, so you're one of the smaller Boards then, too.

DIRECTOR WEICHER: We have four other Board members.

MR. RADWAY: My Board has 18 members, which makes it one of the larger Boards. That has not been a problem in terms of in-person meetings. It makes it more difficult to hold conference calls with substantive discussions, so we have generally adopted a practice that the conference calls are either sort of -- when we need to hold a meeting to go over one or two smaller issues that can be discussed in a matter of that nature, or they're focused on a specific topic and not a whole wide ranging oversight of the Bank.

But the advantage to, frankly, having a larger group like that has, particularly when you don't have any input into who sits on the Board is that having the larger group allows you to be more careful in your selection of subcommittees or committees which do probably the bulk of the work of the Bank, in terms of making sure that you have the right skill sets on each of the committees. So, in that sense, it has actually been a helpful tool to us.

The issue that, it was, I guess a little bit of a disagreement between the members on the first panel related to that I think maybe -- I think the issue of independence. And I guess, I tend to fall more on the side that Mr. Wallison expressed, which was that the independence that is

most important on the Board is the independence from management. If you look at the problems that institutions in the private sector have had in recent years, it has been lack of independence from management that is more important than lack of independence from shareholders. And that it would be a tragedy for the Bank System if there wasn't decent representation of the shareholders on our Boards. And that the most important thing in any corporation is to make sure that there isn't insider dealing and we, obviously, have a huge advantage over other privately held corporations in that regard, since our stock price doesn't fluctuate, which means that there are far fewer ways that one could even create such an opportunity if one wanted to.

DIRECTOR WEICHER: Are there any other comments?

MR. BARONE: I agree with Mike Radway that the size of the Board should be -- should be dictated by the committee work. It would be awfully hard to have a seven member Board with eight committees. The same people -- might as well not have committees and just meet as a Board and do all the work. So, so for us 14 seems to work fine. I think we probably could get along with 11, but I don't think much less than that is going to work.

CHAIRMAN KORSMO: Dr. Mendelowitz.

DIRECTOR MENDELOWITZ: I have sort of three issues that I'd like to raise.

DIRECTOR WEICHER: Can I hear what --

DIRECTOR MENDELOWITZ: Oh, I'm sorry.

MR. MROZ: The other comment I'd make is, again, looking at the particular aspects of each of the Banks and who they represent in terms of their constituencies, then you're going to have, the -- in each district, once again, I think the constituents of the Bank asking for representation. So, more than likely, again, even though it might be ideal to say that a seven-member Board could effectively manage it, along with a practical demands are going to be made of "the Bank" for the representation on the Board, as well as the practical issues of the internal management. I think you're going to find that across the Board, it's going to be bigger than 7 to 11.

MR. MIDDLETON: As the chairman of an 18-person Board, I think we're at the outer limits of a manageable Board. In order to effectively embrace all the areas of responsibility, we do have an active committee System, but it's -- it’s -- I think if we had to go higher, it would start diminishing the returns because there's a lot of movement, there's a lot of interests, diverse interests in getting the issues to a consensus -- as the consensus

gets larger, it's much more time consuming and much more difficult. So, I think we're sort of at the boundaries.

It's workable for a Bank of $116 billion, I think it's a prudent size, but I would be hesitant to go any larger. And I would be very hesitant to go any lower than 14. I think that's a good healthy size. Again, on the committee structure is very important. We do a lot of -- we do the majority of our work in the committees.

CHAIRMAN KORSMO: Dr. Mendelowitz?

DIRECTOR MENDELOWITZ: Thank you, Mr. Chairman. Whether you want to call it a subsidy benefit or an economic grant, Home Loan Banks derive tremendous financial benefit from the GSE status. And when you talk about the independence of Directors, it's not just independence from management, I would say it's also independence from the owner/members. Because, as Mr. Wallison pointed out, the Home Loan Banks have a public mission and having public interest Directors is a way of helping to ensure that the Banks use their subsidy to achieve the public mission, rather than merely enrich the owner/members.

So, I think that our notion of independence has to be thought of in a much more global way than just independence from management, as you would in a publicly traded company with a fiduciary responsibility of the board

of governors is to maximize shareholder value. That wasn't a question, it was sort of a plea to you to think through all the ramifications of independence.

The second question goes to the issue of competence, technical competence of the Boards of Directors. It's clear from the presentation that for a Board of governors to do its job, it needs a full range of skills on the Board of Directors. You do need somebody who's an expert in personnel matters; you need somebody who's a good planner; you need somebody who's an expert in financial management.

I want to thank Mr. Middleton for referencing the proposed reg that was introduced and approved unanimously by this Board last March. And quite honestly, the impetus behind that proposed reg was the fact that looking over the Boards, I found no assurance that either the elected -- even one of the elected Directors or one of the appointed Directors would have the necessary skill to make sure they understood the balance sheet.

I'm embarrassed to be able to say to you that I've had members of Boards of Directors of Home Loan Banks tell me that there was not a single Director, either appointed or elected, who understood the complexities of that Bank's balance sheet.

So, I think that your highlighting that proposed reg, I think, Mr. Chairman, we need to move expeditiously on that. I realize it's one little piece of the puzzle, when we have a much larger set of issues that we're trying to deal with and address. But I think the case is overwhelming that we should move expeditiously to implement and pass in final form that proposed rule. Maybe at the next Board meeting we could do it.

I really have concerns. I'm less worried about that one expert intimidating everybody else or letting everybody else feel they're off the hook. And I am worried about having no one there who really has a sophisticated understanding about the balance sheet. And this is a way can correct that.

Third, as I said before, I'm primarily interested in incentives, rather than punitive measures. But, ultimately, we do have a little power here to remove Directors and Chairmen who don't fulfill their responsibility.

I wanted to get some ideas from you all as the appropriate things on which to remove a chairman, you know exercising our authority for failure to have good governance. For example, if a chairman didn't establish a committee structure to carry out the business of the Board

and good Board practices, would that be a basis for removing a Chairman?

Mr. BARONE: I think that internal to the structures of the -- each Bank that each Bank should take care of that. That -- that -- I think, what was referred to earlier, I don't know which one of the panelists did it, but removing the Director, I think it was Mike, Mike number one who talked about it would be harder for the Finance Board to remove a Director that they had appointed than to remove a Director that they hadn't appointed.

So, I think that -- wasn't that your proposal, that they would have the power to remove a Director, not a chairman?

MR. RADWAY: They have that authority, under current law for cause. My suggestion -- one of the arguments for devolving the public appointment process to the Boards is that the Finance -- I'm not sure whether the Finance Board's actually ever removed a Director, but I think it's certainly arguably less likely that they would admit that they made a mistake and remove somebody that, perhaps, they had some ties to and remove somebody that they had a role in appointing than they would exercise that responsibility if it was someone that they had not been involved in --

MR. BARONE: How would the Finance Board know when a Director isn't performing if the Bank is performing well? If you send your examination team in, for example, and they find that there are no problems and that all of the controls are in place that are supposed to be, et cetera. You could have a Board of 14 with two or three who don't perform and you wouldn't -- you wouldn't know because either management is good or the rest of the Board has compensated.

So I think that this is --

CHAIRMAN KORSMO: I think the only place that fits in now is I think there is a -- there is a regulatory limitation on non-participation.

MR. BARONE: Right, how --

CHAIRMAN KORSMO: Beyond that, obviously, you'd go to the question of the extent and the focus of the examination process that would identify Directors who weren't participating. Mr. Middleton.

MR. MIDDLETON: To your point, in the bylaws of the Atlanta Bank, the Board can remove the position of chair and vice-chair, it's within their power. The chair, of course can remove a committee chair or vice-chair, but we have no provision to remove any Director. So, if your instance -- if your example is how do you get a -- remove a chair from an office, we do it internally.

DIRECTOR MENDELOWITZ: But, we also have the authority here.

MR. MIDDLETON: Correct.

DIRECTOR MENDELOWITZ: And I was trying to get an understanding of how egregious does a chair's performance have to be to merit an easy call on removal? Now, if the chair didn't share information with the other members of the Board of Directors?

MR. MIDDLETON: Wouldn't it bubble up internally from the Board? Sort of a no confidence-type thing and then percolate up to the -- to your Board, I think something along those lines. That, I can see --

MR. JETTER: I think they've already encouraged a little bit. I think governance recommendations had suggested you do Board evaluations where they would generate that.

MR. RADWAY: I think the standards probably already exist in the -- right now for the standards that the FDIC or the Comptroller of the Currency or the Federal Reserve would apply in removing Directors of financial institutions that they regulate.

I mean, obviously the standard has got to be relatively high, it's not just a "we don't like what you're doing." It's got to involve some sort of mismanagement or

financial wrongdoing or something along those lines. But I think there's probably an established set of precedents that could be followed by the Finance Board that have been vigorously used over the last 20, 30 years by the other financial regulators.

DIRECTOR MENDELOWITZ: Thank you.

CHAIRMAN KORSMO: We've kept our panel here for an hour and a half, if--

DIRECTOR WEICHER: May I ask the question I've asked all the other panels and gotten a variety of answers. And discussing with Mr. Wallison in particular this morning. The Home Loan Banks are essentially established to serve the public purpose, to serve a mission and they're given various authorities as Director Mendelowitz was saying. Various privileges in order to achieve that mission and they're expected to achieve that mission without losing money. And so, the role of Bank management, it seems to me is to try to strike the right balance between serving the public purpose or taking risk, if you will -- and avoiding losing -- avoiding losing money.

And I wonder, and I'm going to exempt the president of the Topeka Bank from this one -- but I'm wondering what your sense is of how the Banks, whether the Banks should be taking more risk? Should be more active on

the mission side? Or whether the balance seems to be about right at this point?

MR. BARONE: We, in San Francisco, believe that Banks are taking too much risk. That the balance sheets have too much risk on them relative to what they had five years ago or so.

Probably one of the reasons why San Francisco was slow in doing MPF, those types of programs. Because our Directors simply don't like the risk. So --

MR. RADWAY: I would say that there's a range of appetites for risk within the System. It's not surprising, given that the nature of the constituencies, membership of the individual Banks. On the whether there's too much or too little risk, I would say that the risk is largely there, frankly, because the financial world has dramatically changed over the last 10 or 20 years and it's not the same as it was in the 1930s. And the model that worked and was successful in the 1930s won't work, probably terribly well today. And that has probably prompted the, frankly, demand for some change amongst the membership of a large number of the Federal Home Loan Banks.

DIRECTOR WEICHER: I wasn't restricting that to the Home Loan Banks, we have many witnesses who are not part

of that. I'm talking about your view of it. Are you taking the right amount of risk or too much or too little?

MR. RADWAY: I think, at the moment, as best I can tell, we are taking the right amount of risk, particularly given that our growth in the mortgage business has, although it's been dramatic from a percentage increase, it was still a very small portion of those markets.

And I think the most important thing is how are we managing that risk. We -- you take risk, but you take calculated risks. And if you have the people in place to adequately assess what the risk level is and to make those predictions, then you can take those risks knowledgeably and move forward.

If, on the other hand, you simply, you know, are gambling, obviously, that's a huge problem and that was one of the reasons why my Bank made the decision last year that we had to significantly increase our resources devoted to some of the quantitative analysis and internal controls that we do. Not that we felt that we were inadequate, but that our portfolio was changing; our risk level was changing and we needed to be able to adapt to make sure that we properly managed those risks.

MR. MIDDLETON: I think each Bank has to develop their business plan in the context of their members and

their shareholders and their stakeholders. I know in Atlanta, we're trying to do a prudent growth of that particular category. But as Under Secretary Abernathy said that it's very appropriate for a co-op to serve its members with its product line, so, in Atlanta we're trying to broaden our product lines and manage the risk prudently as possible. But we have to keep the cooperative safe and sound because -- and profitable because our profits help with our mission. And they're mutually inclusive.

So that's how we've sort of designed our business plan to meet the needs of the stakeholders and the shareholders.

MR. MROZ: I would agree with Mike, because and I -- it seems to be -- I'm sorry, Mike Middleton that -- and maybe it's because I come from New Jersey where home rule is so strong. But the concept of bringing a decision about balancing a portfolio back to what the members think and what the issues are, again on the public policy level, in that district are very important. Obviously, the New York District with New Jersey and New York and the islands where there is great demand.

And we've looked at those issues even with the issues with our Bank's portfolio. And during this last quarter we looked at ways to ensure that, for instance, the

AHP program is still viable going into next year, which otherwise could have been problematic for us.

We recognized -- and that was an issue unto our Bank that we had to manage and consider. So, I think it does come back to the Bank and its -- its mission in its district and its constituencies and its members that it needs to serve.

MR. BARONE: It all depends, also, on what you mean by risk. If we go by GAAP earnings, you all know that every Bank's GAAP earnings is fluctuating all around the neighborhood because FAS 133's particular rules and regulations about how to swap callable debt is measured in terms of the hedge is causing all the volatility.

If you look at the economic earnings, especially, I'm sure of almost everybody's Bank, the economic earnings are probably quite consistent and don't fluctuate. So, what does risk mean? And we have had communication from the Board, about developing capital to protect our capital, that is the retained earnings proposal, because -- because we have an accounting rule that doesn't make any sense.

DIRECTOR MENDELOWITZ: Just, forgive me for responding to your question. I'm the hawk on retained earnings. So I have to say something. My concern over

retained earnings and my belief that the System needs to build more retained earnings is related to two things.

One is the variability of the income. And this is, clearly, an accounting issue because of FAS 133. But it's also a recognition of the fact that the System is develop balance sheet with more risk on it. And building retained earnings is appropriate to the level of risk. So that, if you have a Bank that has very little risk on its balance sheet, doesn't invest in AMA, for example. It's need for retained earnings is going to be far less than a Bank where there's, you know, 60, 75 percent of the balance sheet is AMA.

And so, I just wanted to clarify that we're not talking about some debt that is exclusively the result of an accounting artifice. It's part an accounting artifice and much more important, it's a response to the changing profile of risk on the balance sheet.

MR. BARONE: But, so far, I have seen over the years that I've been there, even though interests rates have fluctuated, the earnings don't fluctuate dramatically in the short period of time, they fluctuate over a long period of time and they do so smoothly. So, I can't -- I can't see that, unless we have statistical data that show that these risks are real that we ought to deprive our members of the

dividends that they deserve for their capital, simply because we have a fear.

CHAIRMAN KORSMO: The retained earnings discussion is an important --

DIRECTOR MENDELOWITZ: I’ll be glad to come out with your Board on that.

CHAIRMAN KORSMO: As I've mentioned we've kept these people sitting in these chairs for an hour and a half. Are there any other comments or questions directed at their testimony?

DIRECTOR MENDELOWITZ: Mr. Chairman.

CHAIRMAN KORSMO: Oh, come on now.

DIRECTOR MENDELOWITZ: One last question.

CHAIRMAN KORSMO: I don't believe that.

DIRECTOR MENDELOWITZ: By the way one of the concerns I've always had is about a defect in the corporate governance of a co-op, because of the conflict of interest between a Board member who wears two hats, you know both an owner/member and -- and your reference to this issue of convincing them of the importance of retained earnings. I think is -- that's a classic example of the cross-over from retained earnings to, really, the corporate governance issue. Because whether a co-op can, in fact, build a balance sheet with the appropriate level of retained

earnings without regulatory prodding or intervention, may, in fact, be a question about the appropriateness and the ability of a co-op to exercise appropriate corporate governance over all aspects of the business. Thought for the day.

CHAIRMAN KORSMO: Bob, Andy, Mike and Mike, thank you very much, your testimony has been very helpful. It's certainly given us many ideas and food for thought. Your reaction to some of our ideas has also been productive. We appreciate your willingness to be here and we look forward working with you in the future as we try to move this process along.

Thank you very much. This meeting is adjourned. Thank you.

[Whereupon, at 1:15 p.m., the meeting adjourned.]