ANNALY®

June 23, 2020

Director Mark Calabria
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20219

Re: Federal Home Loan Bank Membership – Request for Input

Dear Director Calabria:

Annaly Capital Management, Inc. ("Annaly") is pleased to respond to the Request for Input on the Federal Housing Finance Agency's ("FHFA's") existing regulations on Federal Home Loan Bank ("FHLBank") membership. Annaly supports the FHFA's focus on preserving the safety and soundness of the FHLBank system and its housing finance and community development mission. It is important that any FHLBank membership framework for new membership types is clear and transparent, and we appreciate the opportunity to comment on requirements related to captive insurance companies owned by mortgage real estate investment trusts ("mortgage REITs" or "mREITs") as one possible approach for mREITs.

Formed in 1996, Annaly is the nation's largest mREIT with nearly $100 billion in assets[1] that support two fundamental sectors of the American economy: housing and small- to mid-sized businesses. Ninety-five percent of our portfolio, or nearly $95 billion[2], helps to provide financing for nearly 700,000 homes[3] for Americans and their families across all 50 states. We are publicly traded and provide critical secondary market liquidity, across agency mortgage-backed securities, residential credit, and multifamily commercial real estate, including capital directly to support origination. Mortgage REITs such as Annaly represent a capital base dedicated to investments in real estate and housing.

In addition, Annaly's corporate responsibility drives positive and sustained value to shareholders, employees and society. Annaly's investment in a joint venture with Capital Impact Partners, a national community development financial institution, supports the vitality of local economies through investments in low- to moderate-income communities. Through this partnership, we've financed over 450 affordable housing units for over 1,000 low- income residents as well as nearly 1.3 million square feet of community development projects supporting education, health care and healthy food access.[4] Furthermore, Annaly was selected as a member of the Bloomberg Gender-Equality Index in 2020 for

Financial data as of March 31, 2020.
[1] Source: Company filings. Includes TBA purchase contracts and CMBX derivatives and shown net of securitized debt of consolidated VIEs.
[2] Source: Company filings. Includes TBA purchase contracts and shown net of securitized debt of consolidated VIEs.
[3] Represents the estimated number of homes financed by Annaly's holdings of Agency mortgage-backed securities, residential whole loans and securities, as well as multifamily commercial real estate loans, securities and equity investments. The number includes all homes related to securities and loans wholly-owned by Annaly and a pro-rata share of homes in securities or equity investments that are partially owned by Annaly.
[4] Figures represent the cumulative impact of Annaly's investments, including current and prior investments, with Capital Impact Partners.

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the third year in a row and is considered a "Winning" Company by 2020 Women on Boards given the 45% female representation on our Board of Directors.

Annaly's captive insurance company, Truman Insurance Company LLC ("Truman"), has been an active member of the FHLBank system in good standing since its membership was established in February 2014. Truman's membership is backed by the strength of Annaly's balance sheet, including an equity base of approximately $13 billion, through a parental guaranty of Truman's FHLBank advances. Annaly's financial strength and resilience has been demonstrated through business cycles and economic dislocations including the financial crisis and the more recent pandemic-induced economic and market volatility.

Fundamental to Annaly's performance is a deep-rooted risk management framework and culture that ensures we are operating at prudent capital and liquidity levels. Annaly's capital ratio has consistently compared favorably to other financial firms, with a most recently reported capital ratio of 12.3%.[5] Likewise, our liquidity management practices are robust, with a strong liquidity position of $6.9 billion[6] of unencumbered assets including cash as of March 31st, 2020. Our business model has afforded our diverse investor base, from asset managers to pension funds to retail investors, the ability to invest in housing and real estate.

Mortgage REITs have played an important role in the evolution of a housing finance system that is more heterogenous than the past and is thus more competitive, accessible and stable.

The housing finance system has evolved meaningfully since the FHLBank Act was established in 1932 to a system that disperses the power to price and distribute mortgage credit beyond the government-sponsored enterprises ("GSEs") and the largest banks. Over decades, the market has evolved from one in which a few large banks sold loans to Fannie Mae and Freddie Mac to one in which credit risk is distributed more broadly across investors. The result is a more competitive, stable and consumer-friendly system with market participants innovating to improve and expand access to credit in ways that are more sustainable than in the years prior to the financial crisis.[7]

Mortgage REITs have become an integral part of this evolution in housing finance, contributing to liquidity for residential mortgages through economic and credit cycles. Legislation to establish real estate investment trusts ("REITs") was passed in 1960, which required that the majority of these institutions' investments be real estate-focused, creating a dedicated capital source and putting REITs at a critical nexus between real estate and capital market investors. Since 2007, the market

[5] Calculated as total stockholders' equity divided by total assets inclusive of outstanding market value of TBA positions and exclusive of consolidated VIEs.
[6] Represents Annaly's excess liquidity and defined as assets that have not been pledged or securitized (generally including cash and cash equivalents, Agency MBS, CRT, Non-Agency MBS, residential mortgage loans, MSRs, reverse repurchase agreements, CRE debt and preferred equity, corporate debt, other unencumbered financial assets and capital stock).
[7] Goodman, Laurie, et al. "The Mortgage Market Has Caught the Virus." Urban Institute, 18 May 2020, www.urban.org/research/publication/mortgage-market-has-caught-virus.

capitalization for mREITs have increased six-fold.[8] Today, mREITs invest $437 billion[9] across real estate finance markets, which represents over 80 percent of mREITs' total assets.

Mortgage REITs provide broad support across all major housing finance channels: agency, government, and non-agency mortgage markets. This serves to lower mortgage rates for borrowers who have many mortgage options as well as helps expand lending options for those who would otherwise have limited access to credit. Mortgage REITs have been particularly critical to supporting lending for borrowers who don't fit neatly within the credit boxes required in agency and bank origination channels, including those who are self-employed, innovating and playing a critical role that strengthens the ecosystem and furthers access to credit overall.

FHLBank membership for mREITs helps provide liquidity to the nonagency market, leading to lower, steadier interest rates for borrowers, while also helping to maintain the FHLBanks' support to mortgage markets.

Since June 2016, Annaly has purchased nearly 12,000 residential mortgage loans to creditworthy borrowers totaling approximately $6 billion from a range of originators including community banks.[10] These mortgage loans were initially financed through our FHLBank line until we were able to issue private label securitizations ("PLS").

Annaly has issued $4.3 billion across 10 PLS, none of which have realized a credit loss to date. Underlying loans include expanded prime credit to:

1) Borrowers who are self-employed or small business owners and, as a result, have difficulty accessing credit because they don't meet requirements, such as having W2 statements, to qualify for a commercial bank portfolio loan or a loan that could be sold to Fannie Mae and Freddie Mac and
2) Agency-eligible investor loans which we were able to price at levels more favorable to borrowers than Fannie Mae and Freddie Mac

Borrower credit in our securitizations has been strong, similar to the underlying borrowers of our FHLBank pledged loans: weighted average original FICO scores over 750, weighted average cumulative loan-to-value ("LTV") ratios under 70% and weighted average debt-to-income ratios under 40%.

Mortgage REITs such as Annaly have helped to jumpstart the PLS market. Since 2017, mREIT sponsors have made up 59%[11] of expanded prime private label issuance and 20%[12] of the prime PLS

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[8] Reflects the increase in mortgage REITs' total equity from December 31, 2007 to March 31, 2020. "Mortgage REITs" represent members of the Bloomberg Mortgage REIT Index as of that date.
[9] Data as of March 31, 2020 and reflects mREIT investments in all residential and commercial mortgages and Agency and GSE-backed securities as indicated in Financial Accounts of the United States: Mortgage Real Estate Investment Trusts, First Quarter 2020, Federal Reserve. https://www.federalreserve.gov/releases/z1/20200611/html/l129m.htm
[10] Annaly calculations. Dollar value reflects unpaid principal balance at acquisition.
[11] Data as of June 10, 2020. Expanded prime securitization shelves are generally representative of borrowers with credit scores above the national average (average credit of selected shelves is 754), but some of the borrowers are either lacking full documentation (89% of borrowers have full documentation), are non-QM, are financing investor properties, are higher LTV borrowers, or are a combination of these risk factors.
[12] Data as of June 10, 2020. Prime securitization shelves are generally representative of borrowers with credit scores above the national average (average credit of selected shelves is 769), where nearly all borrowers have documented income via

issuance, complementing issuance by banks. Securitization helps to expand the investor base in residential mortgage credit beyond bank portfolios and money managers as well as expand credit to borrowers.

However, PLS issuance as a source of financing fluctuates with spread levels and volatility, resulting in execution uncertainty, higher borrower rates and procyclical access to credit. During significant market and credit events, PLS markets retreat, wholly withdrawing credit to certain borrowers. Secondary loan market investors relying solely on PLS markets are challenged to develop long-term business strategies and are less nimble to move into new market segments unless a PLS market has been established in that specific asset class.

The FHLBanks are an alternative source of funding for whole loans that supports lower, more stable and countercyclical borrower rates during periods of securitization market disruptions or volatility, enabling

1) Stable whole loan purchase economics, reducing the level and cyclicality of borrowers' rates
2) Continuity of available mortgage financing for borrowers during periods of securitization market disruptions or volatility, as FHLBank financing provides steady access to funding for lenders otherwise reliant on the securitization market or other less stable correlated funding sources, and
3) Permanent long-term investments in origination and servicing infrastructure, allowing PLS markets to grow steadily over time

Additionally, expanding membership would help the FHLBanks maintain their support to the mortgage market. The ratio of FHLBank advances to single-family mortgage debt outstanding has declined from 7-8% in the early 2000s to 5.7% in 2019, in part due to structural changes in housing finance that aren't reflected in the FHLBanks' membership base.[13]

Financial condition requirements are critically important for any expansion of FHLBank membership in order ensure that member institutions can manage through a range of economic and market environments and to protect the safety and soundness of the FHLBank system.

The FHLBanks generally utilize a number of tools to ensure safety and soundness of the system.

1) FHLBanks require the parent company of an FHLBank member to guarantee the full amount of the advance and limit borrower capacity based on the size of parent company equity
2) FHLBanks require parent company and affiliates financial information on a monthly, quarterly, and annual basis, which is more than typically required under bank financings of similar assets, in addition to reporting required of the captive insurance member
3) FHLBanks over-collateralize advances, generally requiring larger haircuts than bank counterparts while retaining the right to change them at any time, unlike bank counterparties, and requiring margin based on changes in the value of the collateral pledged

W2 (100% of borrowers have full documentation). These borrowers generally receive relatively attractive mortgage rates (average gross WAC of 4.39%).

[13] Kaul, Karan, and Laurie Goodman. "Should Nonbank Mortgage Companies Be Permitted to Become Federal Home Loan Bank Members?" Urban Institute, 16 June 2020, www.urban.org/research/publication/should-nonbank-mortgage-companies-be-permitted-become-federal-home-loan-bank-members.

4) FHLBanks require that members purchase stock, initially and ongoing as advances increase, providing additional overcollateralization

Together, these risk management measures result in reporting and collateralization that is more conservative than other forms of financing. Indeed, the overcollateralization required by the FHLBanks results in haircuts that are higher than that which bank counterparties require. In addition, the overcollateralization implies a more stringent credit enhancement than what the credit agencies require of the AAA-rated bonds in our securitizations of like collateral. The credit rating agencies set the level of overcollateralization on AAA-rated bonds by modeling the amount required for the AAA-rated bonds to pay timely principal and interest despite a 35% house price depreciation.

Additional risk measures could be extended to mREITs to further protect the FHLBank system's conservative risk position, which we take to be critical to their success, and to level the playing field between mREIT parent companies that are not subject to supervision by a prudential safety and soundness regulator and the FHLBanks' historic bank members. In particular, a focus on capital is key:

- A minimum equity base metric such as Shareholders' Equity should be required at a threshold sufficient to support losses through periods of market volatility and deleveraging
- Capital ratios are important for monitoring ongoing financial strength and could be considered as either a balance sheet capital ratio such as Tier 1 Leverage Ratio or a risk-based measure such as Common Equity Tier 1 Capital Ratio. Threshold capital ratio requirements could be comparatively sized relative to 'well capitalized' bank parameters

Currently, Annaly reports other important risk metrics to our FHLBank such as unpledged assets to total financing assets, a liquidity metric, and metrics associated with our liability maturity profile and information on counterparties.

Additionally, with a surveillance and reporting regime, mission requirements and structures that address the possibility of prolonged bankruptcy proceedings, captive insurance company membership for vetted and approved parent company member classes would strengthen our housing finance system without imposing incremental risks to the FHLBank system.

With regards to surveillance and reporting, the FHLBank system may want to maintain a minimum set of requirements that apply to all membership classes. In addition, the FHLBanks could also have requirements that are specific to certain institution types given the different business models of various current and potential FHLBank members.

In addition, FHFA could exercise oversight of mREIT parent companies in the FHLBank system through processes similar to those used to oversee and set requirements for counterparties of Fannie Mae and Freddie Mac, including mortgage sellers/servicers and private mortgage insurers. Through close coordination and the examination process, for example, FHFA could have oversight and set requirement standards as it deems necessary.

To ensure that parent companies are actively engaged in legitimate housing finance activities, they should meet mission requirements such as a housing asset test at initiation of membership and on an ongoing basis as well as be required to demonstrate support to low-to moderate-income housing and community development. Other requirements for mREITs to ensure a commitment to investments that support housing and real estate markets would be to require a minimum number of years operating as a REIT and that the parent company be publicly traded.

Finally, the FHLBanks are likely to be able to fully recover their advances in the case of mREIT bankruptcy due to the super-priority lien granted in the FHLBank Act, varying forms of credit enhancement that provide meaningful loss protection, and, under our proposal, a parent guaranty from an entity with a substantial equity base. Several current member types (or their affiliates pledging collateral) would be resolved under the U.S. Bankruptcy Code of possibly under non-U.S. law, but we understand that some FHLBanks wish to avoid the U.S. Bankruptcy Code as much as possible. Many state-level insurance insolvency regimes specifically allow FHLBanks to quickly access collateral, and there are structural ways to give FHLBanks the same protections for collateral pledged by affiliates of captive insurance companies as they have for collateral owned and pledge by non-captive insurance companies.

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Annaly represents a capital base dedicated to investments in real estate and housing across residential credit, agency mortgage-backed securities and commercial real estate. We couple a strong capital position with prudent risk management and have a more than twenty-year track record managing through many business and economic cycles. Mortgage REIT members such as Annaly in the FHLBank system contribute to a more robust housing finance system and lower, more stable borrower rates. With the appropriate conditions as outlined above, mREIT FHLBank membership can be achieved without increasing risk to the FHLBank system.

Sincerely yours,

David L. Finkelstein
Chief Executive Officer and Chief Investment Officer