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June 23, 2020

Federal Housing Finance Agency
Attention: Division of Federal Home Loan Bank Regulation
400 7th Street, SW, 7th Floor
Washington, D.C. 20219

Re: FHLBank Membership

My law firm, Potomac Law Group, PLLC, represents a long-standing member of the Federal Home Loan Bank (FHLB) which has a strong interest in maintaining the safety and soundness of the FHLB system. For that reason, we are pleased to provide feedback on the Federal Housing Finance Agency's (FHFA's) Request for Input (RFI) on FHLB membership regulations. As detailed below, we see great risk in allowing REITs and other nonbank entities membership in the FHLB system and support prohibiting these entities from becoming de facto FHLB members through use of conduit arrangements.

FHFA requested comment on whether its regulations remain adequate to ensure a safe and sound system to provide liquidity to members while advancing the Federal Home Loan Bank Act's (Bank Act) mission of supporting affordable housing and community development. FHFA has not conducted a review of its membership rules since 2016, when it issued a final rule excluding captive insurance companies from membership in the FHLB system. FHFA found that captive insurers, which differ from traditional insurance companies that are eligible for membership, were being created by parent companies that were ineligible for membership under the Bank Act, including mortgage real estate investment trusts (REITs). By creating these captive insurers, the ineligible parent companies circumvented the Bank Act and obtained access to funding to which they were not legally entitled. The final rule gave captives up to five years to repay existing advances and terminate their membership.

Since that time, REITs and other nonbanks involved in home mortgage origination and servicing have advocated for access to the low-cost funding provided by FHLBs and have attempted to gain access through other types of conduit arrangements.

FHFA seeks input on whether it should amend its regulations to permanently ban from membership entities used as conduit vehicles for companies that are otherwise ineligible for membership and the risks associated with permitting conduits to gain access to the FHLB system.[1]

I. Congress Purposely Limited FHLB Membership

Congress, when passing the Bank Act and establishing the FHLB system, specifically limited membership in the FHLB system to tightly-regulated community banking entities and traditional insurance companies involved in home lending. The Bank Act itself identifies the following entities as potential members of the FHLBs: "savings and loan association . . . insurance company, savings bank, community development financial institution, or any insured depository institution . . . ."[2] These membership limitations imposed by Congress were intended to ensure that the FHLB system provides liquidity for housing finance while simultaneously ensuring the safety and soundness of FHLB system.

Prior to 2016, ineligible parent entities were circumventing the Bank Act to obtain de facto membership through their captives that acted as a conduit to low-cost funding for the ineligible parent or affiliate. In 2016, consistent with Congress's intent to limit FHLB membership, FHFA issued a final rule banning captive insurance companies from membership, noting that captives are not traditional insurance companies involved in home lending. Instead, these captive insurance companies are entities established to provide limited products only to their parent entities or affiliates, which are not otherwise eligible for FHLB membership.

FHFA's 2016 action to restore membership in the FHLB system to Congressional intent should be applauded. We also support a continuation of the approach, as outlined in the RFI, which would prohibit the use of captive insurance companies as conduits for otherwise ineligible entities to gain entry to the FHLB system.

II. Nonbanks Are Not Subject to Prudential Regulation and Safety and Soundness Reviews

One important aspect of FHLB membership is financial health and stability, and traditional, historic FHLB members are subject to significant oversight and regulation targeted at ensuring these objectives. Financial health and stability is critical because FHLB members bear the risk of loss when another member defaults on their system obligations.

Nonbanks and mortgage REITs, however, are not supervised by prudential regulators and are not subject to safety and soundness requirements that apply to regulated banking entities and

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[1]Captive insurance companies were being issued in this manner until FHFA's final rule defined "insurance company" to exclude captives.

[2] 12 U.S.C. § 1424(a)(1). A credit union is considered an insured depository institution. 12 U.S.C. § 1424(a)(5).

traditional insurance companies. The requirements that come from prudential regulation are onerous and include risk-based capital requirements, stringent reviews of internal operations and controls, and review of audit functions. Even if these ineligible companies are subject to state regulation, the level of oversight and substantive review is not the same quality that federal regulators provide, as state regulators tend to focus on consumer protection rather than financial stability and safety and soundness. Because nonbanks are not subject to safety and soundness reviews comparable to that performed by prudential regulators, FHFA cannot rely on evaluations that may exist, if any, and thus has limited ability to assess the company's financial condition.

Mortgage companies that want to become legitimate members of a FHLB can do so by forming a bank or purchasing one. That route requires additional oversight and expense, which may explain why many have pursued the workaround afforded by a captive. However, it is the bank regulatory framework and system for review that provides assurance of the necessary safety and soundness for the system to remain viable and continue to promote affordable housing, even under adverse scenarios.

III. Nonbanks' Liquidity Risk would Increase Risk to FHLB System

The operational and funding structure of nonbanks exposes them to liquidity risk. These entities are often thinly capitalized and have complicated, opaque financial structures that are not subject to regulatory scrutiny – making it unclear whether they could withstand economic downturns and maintain their ability to fulfill their obligations to repay FHLB advances. In 2018, the Brookings Institute published a paper that concluded that nonbanks "are vulnerable to liquidity pressures in both their loan origination and servicing activities . . . [and] have minimal resources to bring to bear in a stress scenario."[3] As nonbanks have increased their market share, especially in loans securitized by Ginnie Mae, liquidity constraints have become a larger risk.

Liquidity concerns and weakened financial status is already a major concern with the COVID-19 pandemic. As a result of the economic consequences of the pandemic, a significant number of borrowers have taken advantage of mortgage forbearance options. While those options provide much-needed, temporary relief to borrowers, they also place an enormous burden on many thinly-capitalized entities servicing those mortgages. Recognizing this new reality, Moody's recently changed its outlook for nonbanks from "stable" to "negative" to reflect the likely deterioration in asset performance and values, profitability and capital position relating to the coronavirus pandemic.[4] The negative outlook also reflects their continuing risk to margin calls on repurchase facilities. Nonbanks typically pledge the value of their mortgage servicing rights (MSRs) as collateral to utilize as much leverage as possible. As a result, these entities lack other capital sources or assets to pledge as collateral in times of crisis. Instead of planning for these events by holding more capital, these entities now seek access to FHLB advances as well as

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[3] Liquidity crisis in the mortgage market, Brookings Papers on Economic Activity, abstract (February 27, 2018)

[4] Moody's revises nonbank mortgage sector outlook to negative due to coronavirus, S&P Global Market Intelligence (April 2, 2020).

other government funding from the Federal Reserve and Treasury. Current FHLB members would be placed at risk if such entities were now afforded membership privileges. The current economic downturn offers a suitable example of why it is critical for FHFA to ensure that member institutions have the capital and financial strength to remain viable during unexpected financial downturns.

IV. <u>Allowing Nonbank Access to FHLB Advances would Create an Improper Transfer of Risk</u>

Each FHLB is a separate, government-chartered, member-owned corporation. Advances are collateralized by member's assets. If a nonbank FHLB member were unable to repay its advances, the FHLB incurs a loss if posted collateral is insufficient to cover all outstanding advances and liquidation costs. This, in turn, exposes all FHLB members to share in such loss.

While FHLBs can seize assets from failing banks and credit unions through agreements with the FDIC and the NCUA to minimize losses, the same does not hold true for nonbanks. The failure of a nonbank would be handled through a bankruptcy proceeding--where creditors generally abound and funds to satisfy obligations generally are scarce.

Throughout the 2008 financial crisis, the FHLBs continued to provide advances to their members without disruption, while other segments of the capital markets ceased to function. In fact, the FHLBs have never sustained a loss on their advances because they have members with sufficient capital to timely repay advances. There is no evidence that nonbanks are sufficiently capitalized to perform similarly, and in fact, the evidence indicates the contrary is true. Though slightly dated, an August 2018 Standard & Poor's report identified the exposure of captive advances for REITs as a weakness in the FHLB system that will exist until all captives are required to exit the FHLB system.[5] The mounting concerns of a nonbank liquidity crisis resulting from the COVID-19 pandemic provides visible confirmation of our concern.

FHFA must not take actions that would risk the FHLBs ability to remain a stable, reliable source of funding for members to help them provide lendable funds for the local communities they serve.

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FHLB membership purposely is limited to select entities that maintain strong capital requirements and are subject to regular safety and soundness exams. REITs and other nonbank entities are not subject to prudential regulatory oversight or safety and soundness reviews. They are thinly-capitalized and not well equipped to withstand downturns in the economy or other stress events. Allowing these entities to become de facto FHLB members through use of conduit arrangements would present significant risk to an otherwise stable and safe system and

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[5] S&P Global Ratings, 8/1/18.

improperly transfer risk to the FHLBs and their members. Particularly given the recent economic events, now is not the time for the FHLB system to take on more risk.

Respectfully submitted,

/s/ *Neil H. Koslowe*

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