FHLB Chicago

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VIA E-MAIL TO REGCOMMENTS@FHFA.GOV

Alfred M. Pollard, Esq., General Counsel
Attention: Comments/RIN 2590-AA39
Federal Housing Finance Agency
400 Seventh Street SW, Eighth Floor
Washington, D.C. 20024

Re: Notice of Proposed Rulemaking; Request for Comments – Members of the Federal Home Loan Banks

Dear Mr. Pollard:

The Federal Home Loan Bank of Chicago ("FHLBC") is writing to comment on the Federal Housing Finance Agency's ("FHFA") notice of proposed rulemaking and request for comments on "Members of the Federal Home Loan Banks" published on September 12, 2014 ("NPR"). The NPR reviews current statutory and regulatory provisions governing Federal Home Loan Bank ("FHLB") membership, proposes regulatory changes to the eligibility requirements for membership, and invites comments on all aspects of the NPR. The FHLBC appreciates the opportunity to submit the following comments.

I. This Proposal Is Unnecessary – The Current Regulations Work Well.

The existing regulations already ensure members maintain a nexus to the FHLBs' housing finance mission. The most evident example is the requirement that advances must be supported by mortgage-related collateral. An exception is made for community financial institutions, which can pledge alternative forms of collateral including small business, agri-business and agricultural collateral, as allowed by Congress. By definition, these forms of collateral are mission-consistent and therefore tie the uses of the advances to the holdings of the members obtaining them. Another example is the requirement that the amount of long-term advances that can be made to a member are limited by the amount of total long-term residential housing assets currently held by that member. Further, members accessing long-term advances or Community Investment Cash Advance funding are selected randomly every two years by the FHFA to complete a Community Support Statement certifying that they actively support the first-time homebuyer market. In short, current regulations ensure a housing finance tie exists between our members' holdings and their FHLB borrowings.

The current regulations on membership eligibility also work well and do not need to be changed. The NPR fails to offer a compelling rationale to propose requiring, for the first time in the 82-year history of the FHLBs, ongoing requirements that all members would need to meet in order to maintain their membership. The regulations have always been focused on requiring

members to demonstrate sufficient mortgage loan holdings at the time of application. The NPR states the proposed changes are necessary to avoid the possibility that an institution might reduce or eliminate its holdings after becoming a member. However, no data or empirical evidence is cited to support the claim that this problem is widespread or has harmed the ability of the FHLBs to perform our Congressionally mandated mission.

These views were echoed by Congressman Barney Frank, then-Ranking Member on the U.S. House of Representatives' Committee on Financial Services, in his May 25, 2011 comment letter urging the FHFA to withdraw its Advanced Notice of Proposed Rulemaking ("ANPR") on this same subject. Mr. Frank wrote, "Because the existing regulations seem to me to be functioning properly, I do not see a reason to change them now. As the FHFA notes in the ANPR, it does not have any evidence that significant numbers of members that were required to hold 10 percent of their total assets in residential mortgage loans in order to join the Federal Home Loan Bank (FHLB) system have substantially reduced these holdings after becoming members.… The FHLB system plays an important role in helping to provide liquidity in the financial system, and I believe that changes to the membership requirements could have the unintended consequence of disrupting the stability of the FHLB system while our economy is still struggling."

These concerns remain valid today. In fact, the FHFA's own research shows that 97% of the banks and credit unions subject to the proposed 10% requirement would comply while the vast majority of the remaining members would meet the proposed 1% test (99.2% of commercial banks and savings associations; 98.8% of credit unions; and 83.4% of insurance companies). This data was cited to show the minimal impact of the proposal, but it more clearly demonstrates the lack of a significant problem justifying such a sweeping and potentially disruptive proposal. The current rules have worked well for decades. Before imposing new requirements affecting every member, the FHFA should better articulate why these changes are necessary.

2. <u>This Proposal Will Undermine the Reliability of FHLBs as Sources of Liquidity.</u>

The requirement that members must continually maintain a certain percent of their balance sheet in housing-related assets would severely undermine the reliability of the FHLBs as sources of liquidity, particularly during times of economic distress. It would fundamentally alter the FHLBs' relationship with our members and impair our ability to advance our mission of providing liquidity to support housing finance markets and the U.S. financial markets generally.

The FHFA has noted in its "Strategic Plan: Fiscal Years 2015-2019" that, "the FHLBanks' core mission is to serve as a reliable source of liquidity for their member institutions in support of housing finance and community lending." The value of that liquidity was convincingly demonstrated during 2007 and 2008 when the FHLBs provided approximately $370 billion of additional funding to our members, all of which was fully secured and fully capitalized. Our actions helped to stabilize the U.S. financial system when it needed it the most. More recently, our members have relied upon FHLB liquidity to purchase high quality liquid assets, such as U.S. Treasuries, in order to satisfy new liquidity requirements under the Basel III capital and liquidity regime.

This proposal would undermine that time-tested reliability. By imposing ongoing requirements that restrict FHLB membership, members could no longer be certain that when the next crisis hits, they will be allowed access to our funding. They would have no certainty that they will always remain in compliance with the FHFA's requirements. During a crisis, collateral values can fall precipitously, changing the ratio of housing related assets to total assets, potentially placing them out of compliance. While the test is over a long-term period, collateral values may be suppressed for a longer period.

Members could fail to comply as a result of other activities. A member that merges with an institution that has few housing-related assets could cause the surviving member to fall out of compliance. A community bank that merges or grows organically above the CFI limit, which is adjusted annually, could fall out of compliance when its housing asset requirement jumps from 1 percent to 10 percent of total assets. Shifting between CFI status occurs frequently. In fact, since 2008, 5,622 current FHLB members have been a CFI at some point, but only 5,253 have continuously been a CFI. Such common business events should not penalize members or threaten their access to liquidity.

A dangerous precedent would be set if the FHFA begins establishing ongoing eligibility requirements for FHLB membership. Even if members work to meet the proposed tests, they could never be certain that the requirements might not be increased in the future by the FHFA, under the current or a future Director. Their balance sheets always would be subject to the changing views of a regulator as to whether they were sufficiently devoted to housing finance, potentially politicizing their membership and access to the FHLBs.

The potential effect on FHLB liquidity extends beyond the FHLB System. By undermining the reliability of FHLBs as liquidity sources, this proposal contradicts the efforts of state and federal regulators, such as the Federal Reserve, FDIC, OCC, and NCUA, which have been working to bolster access to reliable liquidity for the financial institutions they supervise. In the wake of the financial crisis, banking regulators better understand the value of reliable liquidity, in addition to the traditional emphasis on building capital. The Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirement embodied within Basel III are examples of a renewed appreciation of the importance of liquidity during economic downturns. Many of our members cite their access to our funding as a key component in the liquidity plans they present to their regulators. As these regulators work to improve the U.S. financial structure, this proposal potentially weakens it. The FHFA seeks to kick out existing FHLB members and threatens others with termination if they fail to comply with its arbitrary tests. These proposed measures could weaken the broader financial system, while doing nothing to help prevent a repeat of the financial crisis.

3. The Impact of this Proposal on the FHLBs and our Members Could Be Severe.

The proposed tests would negatively impact membership in the FHLB System. The charts below show the potential impact of members failing the proposed ongoing membership requirements on the FHLB System level as well as the impact on membership at the FHLBC.

FHLB System—All FHLB Members who failed any test at least once from 2008-2013 or would otherwise be ineligible due to the NPR (based on 2Q2014 data)

Subset of Members who failed	*# of Failures*	*Advances ($)*	*Letters of Credit ($)*	*Pledged Collateral ($)*	*Estimated Total Collateral ($)*	*Total Borrowing Capacity Lost (60% of Total Collateral) ($)*
Members who failed any of the 1% and 10% tests	178	30,676,651,436	262,561,048	74,791,007,817	178,987,205,830	107,392,323,498
Members who failed any of the 2% and 10% tests	253	37,002,765,272	432,118,276	103,472,218,753	197,071,860,682	118,243,116,409
Members who failed any of the 5% and 10% tests	567	55,699,396,869	1,611,744,795	122,958,502,614	523,586,164,573	314,151,698,744

FHLBC—All FHLBC Members who failed any test at least once from 2008-2013 or would otherwise be ineligible due to the NPR (based on 2Q2014 data)

Subset of Members who failed	*# of Failures*	*Advances ($)*	*Letters of Credit ($)*	*Pledged Collateral ($)*	*Estimate Total Collateral ($)*	*Total Borrowing Capacity Lost (60% of Total Collateral) ($)*
Members who failed any of the 1% and 10% tests	11	5,656,510,000	-	29,136,658,182	62,505,527,523	37,503,316,514
Members who failed any of the 2% and 10% tests	13	5,656,520,000	-	29,144,870,816	62,595,983,523	37,557,590,114
Members who failed any of the 5% and 10% tests	29	5,712,432,000	310,477,059	29,664,394,316	85,613,973,367	51,368,384,020

Additionally the proposed ongoing tests would unduly affect insurance company members. More than 21 percent of insurance company members would have failed an ongoing 1 percent test, or would have been ineligible due to the NPR, at least once during the 2008-2013 time period. If the test were set at 5 percent, that number leaps to 46 percent. The failure rates among the different categories of insurance companies are very significant as well. Twenty-one percent of P&C insurance company members would have failed an ongoing 1 percent test while 10 percent of life insurance company members would have failed at the 1 percent requirement. If the FHFA chose to require a higher percentage, such as 5 percent, the numbers of insurance company members that would have failed rises significantly to 46 percent for life insurance companies and 39 percent of P&C companies. And, of course, 100 percent of captive insurance companies would have been ineligible under the NPR and had their memberships terminated.

If liquidity is restricted as a consequence for ongoing membership requirements, the impact will be disproportionately felt by our smaller members, the vast majority of which lack access to another source of reliable, economical funding on a same-day basis. And when community institutions are harmed, the impacts are felt by the smaller, more rural communities typically served by such members.

These smaller, rural communities would also be impacted by potentially removing Affordable Housing Program ("AHP") funds from their communities. These communities may already be underserved due to the limited number of financial institutions and non-profit organizations that serve these areas. By terminating FHLBC membership for institutions serving these areas due to noncompliance with an ongoing requirement would be negatively impacting these communities twice, the loss of liquidity and also the loss of AHP funds.

The amount of available AHP funds may also be negatively impacted since if members are being forced to terminate their memberships, or potential applicants chose not to apply due to the uncertainty of membership, the FHLBC's future income could decrease, thus reducing the amount of money available for AHP.

4. <u>This Proposal Will Limit Access to the Secondary Market</u>

Constricting membership as proposed will also harm our smaller members by limiting their access to housing finance and the secondary markets through the Mortgage Partnership Finance® Program. The FHLBC created the MPF® Program in 1997 and operates the back-office functions on behalf of the 10 FHLBs that currently offer it to their members. This program has proven very popular with our members because it provides them with an opportunity to access the secondary market while importantly preserving their customer relationships. Over 1,400 FHLB members – 84% of which are CFIs -- have used the MPF Program to originate about 1.5 million mortgages, worth more than $220 Billion, in all 50 states plus the District of Columbia, Puerto Rico, the U.S. Virgin Islands, and Guam.

By utilizing the MPF Program, smaller members are able to continue lending in their communities thus benefiting their communities. However, by implementing ongoing membership requirements, the NPR could negatively impact these smaller communities if their local banks fail the tests and have their memberships terminated, thus removing investments by these community banks in their communities. As the Administration works to repair and restart the housing market and increase the availability of mortgage credit, particularly for lower income families, this proposal undermines that effort.

Additionally, by adopting a fixed asset test, the NPR also does not take into account a member's "flow" mortgage business. A member may originate many mortgages throughout the year but sell them into the secondary market. Because those mortgages are sold and are no longer on the member's balance sheet, the member may fail to comply with the proposal and could see its membership terminated even though it would be actively engaged in the housing finance business. While the NPR requests comments on whether "flow" information should be

collected and if so, how an FHLB should be required to obtain the necessary data, the NPR does not offer any solutions for how an FHLB would calculate a member's "flow" business that would not cause an undue burden on the member and the FHLB.

5. Lending To Captive Insurance Companies Can Promote the Housing Finance Mission

Insurance companies have been eligible to become FHLB members since the FHLBs were created in 1932. The FHLB Act states that "[a]ny building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, and savings bank, community development financial institution, or any insured depository institution . . . , shall be eligible to become a member of a Federal Home Loan Bank . . . ." While the FHLB Act does not define "insurance company," the FHFA is proposing to arbitrarily exclude captive insurance companies from membership eligibility without clearly articulating a safety and soundness concern unique to captives. Citing only a "belief" that some captives may be formed by other companies, including real estate investment trusts (REITs), to access FHLB funding, the NPR provides no specific evidence of its claims or any discussion of the ways in which such practices would threaten the FHLBs' mission, given the FHFA's current regulatory protections.

Regardless of the FHFA's intent to exclude captive insurance companies from the definition of "insurance company," the fact remains: captive insurance companies are insurance companies. Captive insurance companies are formed to underwrite risks of both affiliated and nonaffiliated entities. As state insurance commissioners commented on the ANPR, captives are subject to the same regulatory bodies and oversight as are other insurance companies including regulatory requirements for supervision, conservation, rehabilitation, receivership and liquidation. Additionally, similar to other insurers, the ability of a captive insurance company to either lend money or pay dividends to affiliated organizations is tightly regulated and generally requires prior review and written approval from the state insurance commissioner. The FHFA should not be dictating the types of permissible insurance products for insurance company members, or for any members.

The NPR focuses on entities that are not eligible to become members (i.e., REITs) using captives to gain access to the FHLB System. However, the parent of an eligible member, whether the parent is a REIT or a bank holding company, should not affect the eligibility of membership for its subsidiaries. The parent corporation should be allowed to choose the financial charter of its subsidiaries that is most appropriate for its situation and eligible entities that became members should not be expelled from membership simply for having a parent company that is ineligible for membership.

The importance of captives, and REITs, in furthering the FHLB's mission has been highlighted by the U.S. Treasury Department. Michael Stegman, an advisor to the Treasury Secretary recently pointed out that while advances made to captive members pose "potential incremental risks to the FHLB System," the activities of REITs in providing an important source of private capital for the housing market appear to be aligned with the housing finance mission of the FHLBs.

However, any incremental risks that captives may pose to the FHLBs currently exist for another eligible member class, non-depository CDFIs. Non-depository CDFIs do not have a federal or state regulator and there can be limited financial information available, however, the FHLBs currently monitor and manage the potential risks associated with lending to them. Despite these incremental risks, the FHFA is not proposing to terminate the memberships of non-depository CDFIs.

6. Congress Has A Clear Preference Of An Expansive Role For The FHLBs.

This proposal is not aligned with Congress's preference toward an expansive view of the FHLB's reach and mission. Since passage of the FHLB Act in 1932, Congress has reconsidered and amended the FHLB Act many times. These changes demonstrate a clear preference for expanding the FHLBs' mission beyond a narrow focus on housing finance. In recent decades, provisions affecting the FHLBs were included in FIRREA (1989), the Gramm-Leach-Bliley Act (1999), the Housing and Economic Recovery Act of 2008 (HERA) and again in 2010 with the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Each time, Congress chose to broaden or expand the FHLBs reach, by expanding the types of financial institutions that are eligible to become members, by expanding the FHLBs' mission by broadening the types of collateral that can be pledged to support advances, or by exempting the FHLBs from provisions affecting other financial institutions. Notably, Congress has never contracted the scope and reach of the FHLBs.

Each time Congress considered these bills there was an opportunity for Congress to include any of the requirements proposed by the NPR. If Congress was concerned that the FHLBs were not sufficiently focused on their housing finance mission or that the requirements at the time of application might be disregarded after membership was obtained or about captive insurance companies becoming members of the FHLBs, or about REITs using the captive structure to join the FHLBs, or about the definition of the principal place of business, Congress had the opportunity to make changes. Yet, it never has. To our knowledge, none of the proposals of the NPR have even been included in any bill that has been introduced in Congress, much less passed out of any committee or House.

Currently several bills are under Congressional consideration to restructure and reform the GSEs, including the FHLBs. Every bill introduced to date has included provisions about the FHLBs, typically about a role for the FHLBs to perform in the future housing finance system. So Congress is clearly considering changes to the FHLBs even today. Yet, none of these bills has included any provisions that would restrict membership in any way, or impose an ongoing eligibility test, or excluded certain types of existing members from membership. If any individual Member of Congress, much less Congress as a body, is concerned about these issues, they have yet to make such concerns public.

It is also notable that the FHFA has never proposed to Congress that it should make such changes, even after 136 negative comment letters were received in response to the ANPR, including letters from the then-Chairman and then-Ranking Member of the House Financial

Services Committee. The FHFA annually submits its reports on the FHLBs to Congress, yet never brought any of its concerns about these issues to the attention of Congress.

7. Member Termination Is Unnecessary and Unjustified.

The Proposal would terminate the memberships of existing captive insurance companies and terminate any member that fails to comply with its housing asset tests. Because the FHFA is not the primary regulator of our members, terminating their membership in their FHLB is the ultimate sanction the FHFA can impose upon our members. It should reserve such authority only to extreme cases. Lesser sanctions can be sufficient to accomplish its stated goal of ensuring a housing finance nexus. The FHFA has ample examination and oversight authority to deal with any real supervisory concerns caused by captive insurance companies owned by REITs. FHFA should balance the legalistic rationale for this proposal against the practical consequences that will result.

By terminating members that failed to comply with the proposed tests, the capital stock base of the FHLBC would become more volatile and less stable as stock is redeemed or repurchased. This could impact the capital adequacy of the FHLBC and its effectiveness in meeting housing finance and community development policy objectives.

Additionally, the NPR does not address whether members terminated due to noncompliance with one of the ongoing membership requirements would be subject to the five-year prohibition on readmission or whether they could be re-qualified as soon as they were able to show that they were back in compliance with the requirement. The NPR does not discuss the effect of mandatory termination under the stock redemption periods and leaves unanswered the question of whether a terminated member that continues to hold stock in the FHLBC but comes into compliance prior to its stock being redeemed would be able to remain a member upon showing compliance with the requirement.

By proposing to impose new on-going membership requirements with no specific explanation of the actual problem the FHFA seeks to address, and threatening members with termination for non-compliance, the NPR is unduly harsh and burdensome, particularly when the FHFA has failed to explore other alternative options for addressing the perceived problems. We recommend that the FHFA follow President Obama's 2011 Executive Order on Federal regulations that encourages a more balanced approach and emphasizes that Federal regulators should find the simplest, least costly and *least burdensome* way to implement new regulations.

8. Redefining A Member's Principal Place of Business Is Not Necessary.

The NPR attempts to clarify how an FHLB should determine the "principal place of business" of an insurance company or CDFI for purposes of membership. The current regulation defines an institution's "principal place of business" as the state in which it maintains its home office, which is typically the state of domicile. The NPR adds a second component for insurance

companies and CDFIs requiring those institutions to conduct business operations from the home office in order for that state to be considered its principal place of business.

Insurance companies are created, governed and regulated by state law. Insurance companies are subject to pervasive and ongoing regulation and contact with their domiciliary states, including being subject to comprehensive examinations and ongoing reporting requirements, and being required to obtain regulatory approval prior any merger, acquisition or consolidation. The corporate powers of an insurance company such as the authority to borrow and pledge assets to secure borrowings are governed by the state of domicile's insurance code. Additionally, the insurance company's state of domicile's insurance department will regulate, inspect and oversee the insurance company including in the event the insurance company is rehabilitated or liquidated.

Pursuant to the FHFA's Advisory Bulletin on the Collateralization of Advances and Other Credit Products to Insurance Company Members (AB 2013-09), the FHFA requires each FHLB to communicate with the insurance regulator in each state in which it has members and that each FHLB be thoroughly familiar with the state insurance laws. The changes proposed by the NPR would require an FHLB potentially to be in contact with numerous insurance regulators outside its district. But more importantly, the impact of the proposed changes on the state insurance regulators could be significant. Since each FHLB has its own capital stock plan and lending and collateral arrangements, the state insurance regulator would have to understand how each individual FHLB operates. A state of domicile test limits the number of different FHLB relationships in which an individual state insurance regulator must engage.

9. Requiring Audited Financial Statements Poses an Undue Burden on Insurance Companies.

The NPR proposes to require an insurance company applicant to submit its most recent audited financial statements prepared in accordance with generally accepted accounting principles (GAAP), if available, as part of its application. If no such financial statements are available, the applicant may submit financial statements prepared in accordance with statutory principles.

The FHLBC feels that this change would impose a hardship on insurance companies. Some state regulators do not require the insurance companies that they regulate to submit audited financial statements. For insurance companies that either do not, or are not required to, obtain audited financial statements, implementing this requirement could impose a financial burden on these insurance companies. This would require an insurance company to weigh the benefits of FHLBC membership against the costs associated with obtaining audited financial statements.

The FHFA has not provided any statistics that insurance companies are being admitted to the FHLB System that do not satisfy the financial condition requirement. Therefore, the FHLBC requests that this change not be implemented and that the current regulation which allows the FHLBC to review the applicant's most recent regulatory financial report remain unchanged.

Conclusion

For the reasons stated above, the FHLBC respectfully requests the withdrawal of this proposal. The existing regulations work well to ensure an adequate nexus between our members' holdings and their borrowings. This proposal threatens to fundamentally alter the relationship the FHLBs have with our members and change the cooperative structure that has proved so successful. The reliability of the FHLBs as liquidity sources that has served our members and the financial system so well must be preserved. The FHFA has failed to clearly articulate a compelling problem that exists. Any supervisory concerns can be handled by the FHFA without resorting to the most drastic penalty it can impose upon a member – termination. The disruptive and unintended consequences to our members, the FHLBs and the U.S. financial system far outweigh any perceived benefits that might be achieved.

We greatly appreciate your consideration of these comments.

Sincerely,

Matthew R. Feldman
President & Chief Executive Officer