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October 31, 2014

SUBMITTED VIA INTERNET

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
400 Seventh Street, S.W.
Washington, D.C. 20024

Re: RIN 2590-AA39 Members of Federal Home Loan Banks

Dear Mr. Pollard:

This Firm represents several companies that operate captive insurance companies that are a member of or were expecting to be approved as a member of a Federal Home Loan Bank ("FHLB"). We are writing to the Federal Housing Finance Agency ("FHFA") in response to its proposed rule ("Proposal") regarding membership in an FHLB and to underscore the unnecessary harm to housing finance and our clients' businesses that would result from the Proposal. We appreciate the opportunity to do so and hope that our comments will be constructive to the process.

1. Recommendation to the FHFA

We respectfully submit that the Proposal should be withdrawn, at least with regard to the provisions that would purport to treat captive insurance companies differently from other insurance companies ("Captive Proposal"), because the FHFA:

- Lacks legal authority to discriminate against captive insurance companies;
- Is usurping the legislative prerogative of the Congress;
- Is acting in an arbitrary and capricious manner;
- Discriminates unwarrantedly against captive insurance companies and its action would harm housing finance;
- Lacks the authority to mandate the termination of FHLB members; and
- Would likely give rise to claims against the United States for the taking of private property without adequate compensation.

2. **Summary of the Comment**

We believe that the FHFA's Captive Proposal is contrary to law because it would redefine the clear terms and structure of the Federal Home Loan Bank Act ("FHLB Act") by carving out an entire category of insurance companies from the term "insurance company." The FHLB Act is unambiguous in its mandate that "***any***" insurance company may be eligible for membership in an FHLB. Moreover, any such effort to expel captive insurance companies from FHLB membership must demonstrate reasonable justification, consideration of less intrusive alternatives and a compelling cost-benefit analysis to avoid being found to be arbitrary and capricious.

Compounding its usurpation of Congress's legislative power, the Captive Proposal would also usurp the sole authority of FHLB boards of directors to terminate FHLB membership by compelling them to expel all captive insurance companies. Such an arbitrary expulsion of captive insurance companies from FHLB membership would likely give rise to claims against the United States by such expelled members for a taking of private property without adequate compensation.

Given the straightforward membership eligibility standards set forth in the FHLB Act and more than adequate underwriting tools that the FHLBs have to address any legitimate prudential issues, we urge the FHFA not to proceed down a path that is likely to lead to less housing liquidity and various claims of illegal, unfair and arbitrary and capricious treatment of current and prospective members.

Furthermore, we believe that federal public policy strongly supports private sector participation in the housing finance market and that the Captive Proposal is directly contrary to that policy.

In light of the foregoing, in order to eliminate an unfair and unwarranted taint on captive insurance companies, we recommend that the FHFA promptly act to withdraw the Captive Proposal.[1]

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[1] The pendency of the Captive Proposal does serious damage to current and prospective captive members of the FHLB System. The fact that it would require the immediate termination of a captive insurance company whose membership was approved after the date of publication of the Captive Proposal, effectively hamstrings the ability of FHLBs to carry out their legal responsibilities concerning membership applications. More importantly, it puts current and prospective captive insurance company members in limbo until the FHFA acknowledges the clear eligibility of captives in accordance with applicable law, and the FHLBs know that they may proceed to approve and do business with captive insurance members without regulatory penalty.

3. What Are the Regulatory Issues that the Captive Proposal Seeks to Remedy?

The FHFA purports to address concerns that captives are being used by institutions not otherwise eligible for membership to take advantage of the benefits of FHLB advances.[2] The FHFA indicates that its concerns are increased where the amount of advances sought by the captive are far larger than the captive's insurance liabilities, or are comparable to the total assets of the captive. Even assuming for the sake of argument that those are appropriate areas for regulatory intervention, it is unclear why they would be applied only to captives.

Of critical legal significance to this rulemaking proceeding is the fact that the Captive Proposal does not establish a factual record demonstrating that:

- FHLBs have been approving membership applications of captive insurance companies that do not meet the Housing Finance Requirements (as described below) or that do not meet the Safety and Soundness Requirements (as described below);
- Captive members have caused any losses to any FHLB, whether because of their corporate affiliation or operations;
- Captive members have been the focus of any regulatory or enforcement actions related to any improper conduct or any loss exposure that they have created; or
- The FHFA has conducted any studies or research to support the approach taken in the Captive Proposal.

It is impossible for commenters to provide meaningful input on the Captive Proposal when the precise regulatory concern, loss potential or statutory violation has not been explained to the public. The Captive Proposal should be withdrawn on that basis alone.

4. What Does the Law Require?

The Administrative Procedure Act ("APA") requires that regulations adopted by the FHFA not be contrary to law or arbitrary and capricious.[3]

Section 4(a) of the FHLB Act sets forth the criteria that Congress established for membership in an FHLB.[4] The FHFA has issued regulations implementing these criteria with

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2 Members of the Federal Home Loan Banks, 79 Fed. Reg. 54848, 54853 (Sept. 12, 2014) ("Proposal").

3 5 U.S.C. § 706.

4 12 U.S.C. § 1424(a). Section 4(a)(1) provides that the criteria for FHLB membership includes:

> (a) **Criteria for eligibility**
>
> **(1) In general**

respect to insurance companies and other categories of eligible financial institutions ("Membership Regulations").

In addition to the requirement that an insurance company be organized under state law and regulated as an insurance company by a state insurance department, section 4(a) of the FHLB Act and the Membership Regulations issued thereunder establish only two fundamental requirements for their membership eligibility.

An FHLB must determine that the insurance company applicant:

- Makes long-term home mortgage loans;[5] and has a housing financing policy that is consistent with sound and economical home financing ("Housing Finance Requirements");[6] and

- The financial condition of the insurance company is such that advances may be made to the company;[7] and the character of the insurance company applicant's management is consistent with sound and economical home financing ("Safety and Soundness Requirements").[8]

> Any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, community development financial institution, or any insured depository institution (as defined in section 1422 of this title), shall be eligible to become a member of a Federal Home Loan Bank if such institution –
>
> (A) is duly organized under the laws of any State or of the United States;
>
> (B) is subject to inspection and regulation under the banking laws, or under similar laws, of the State or of the United States, . . . ; and
>
> (C) makes such home mortgage loans as, in the judgment of the Director are long-term loans . . . .

12 U.S.C. § 1424(a)(1).

5 12 U.S.C. § 1424(a)(1)(C); 12 C.F.R. § 1263.6(a)(3).

6 12 U.S.C. § 1424(a)(2)(C); 12 C.F.R. § 1263.6(a)(6).

7 12 U.S.C. § 1424(a)(2)(B); 12 C.F.R. § 1263.6(a)(4).

8 12 U.S.C. § 1424(a)(2)(C); 12 C.F.R. § 1263.6(a)(5).

5. How Does The Captive Proposal Deviate from the Law and Sound Public Policy?

5.1. The Plain Language of the FHLB Act Authorizes FHLBs to Accept Captive Insurance Companies as Members

Where Congress has spoken in plain language, an agency is not free to ignore the directive of Congress and impose its view of what would be appropriate legislation. Courts routinely strike down regulatory actions that are at odds with the plain language of the applicable statute as being contrary to law.[9] We believe the FHFA's effort to establish a regulatory definition of the term "insurance company" that would categorically exclude captive insurance companies from FHLB membership is at odds with the plain language of the statute.

Both section 4(a)(1) of the FHLB Act and section 1263.6(a) of the FHFA's Membership Regulations list an "insurance company" as being among the types of institutions that are eligible for FHLB membership. Neither provision, however, defines that term.

The Captive Proposal argues that where a statute does not define a term, the FHFA has the authority to define it by regulation to give effect to the purpose and intent of the statute.[10] This is the basis upon which the FHFA then proposes to rewrite Congress's decision to allow all insurance companies that meet the requirements of section 4(a)(1) to be FHLB members. However, an examination of section 4(a) of the FHLB Act leaves no doubt as to the entities Congress intended to be eligible for FHLB membership as "insurance companies."

Since 1932, section 4(a) of the FHLB Act provides in relevant part that membership eligibility is available to ***any*** "insurance company" that (i) is duly organized under the laws of any State or the United States,[11] and (ii) is subject to inspection and regulation under the banking laws, or similar laws, of the State or of the United States.[12]

The statements of the FHFA's predecessor, the Federal Housing Finance Board ("FHFB"), demonstrate that there was no uncertainty as to what an eligible insurance company is. In 1992, the FHFB issued a proposed rule regarding FHLB membership in response to changes made to the FHLB Act in the Financial Institutions Reform, Recovery and Enforcement Act of 1989. In it, the FHFB noted that all regulated insurance companies have been eligible to

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9 Under the APA a reviewing court shall set aside agency action that is not in accordance with law or in excess of statutory jurisdiction, authority, or limitations, or short of statutory right. 5 U.S.C. § 706(2)(A), (C).

10 Proposal at 54853.

11 12 U.S.C. § 1424(a)(1)(A).

12 12 U.S.C. § 1424(a)(1)(B).

become members of the FHLB System since the original enactment of the FHLB Act in 1932.[13] An "insurance company" only needs to be an insurance company regulated by one or more state insurance departments and be organized under the laws of a state or under federal law.

5.2. The Captive Proposal Usurps Legislative Authority That Belongs Only to Congress

5.2.1. The Captive Proposal Goes Beyond the Parameters of Reasonable Agency Authority

The Captive Proposal would bar captive insurance companies as a class from FHLB membership and purport to force the expulsion of all captives from membership by arbitrarily redefining "insurance company" to be a company whose primary business is the underwriting of insurance for nonaffiliated persons or entities. No such words, inferences, or hints in the statute support such an exclusory definition. As section 4(a) provides, captive insurance companies are organized under state law and regulated by state insurance departments as an insurance company. Thus, they are eligible for FHLB membership.

The Captive Proposal in effect creates membership ***ineligibility*** criteria never contemplated by Congress ("Special Captive Ineligibility Criteria"), which would, in effect, require an FHLB to determine that a captive insurance company:

- Was created to serve as a funding conduit for FHLB advances to a parent or affiliate of the captive insurance company, which is itself not eligible for FHLB membership;

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[13] The FHFB explained its understanding as to what constituted an insurance company eligible for FHLB membership:

> a. *The institution is duly organized under the laws of any State or of the United States. 12 U.S.C. 1424(a)(1)(A).* This requirement is straightforward and presumably would be satisfied by all insurance company applicants. *See* proposed § 933.3(a)(1).
>
> b. *The institution is subject to inspection and regulation under the banking laws, or under similar laws, of any state or of the United States.* 12 U.S.C. 1424(a)(1)(B). *See* proposed § 933.3(a)(2). All insurance companies are subject to inspection and regulation by state insurance departments in their state of incorporation, as well as by the states in which they are licensed to do business. State insurance laws are similar to Federal banking laws in that they require regulatory monitoring of compliance with minimum capital and reserve requirements, financial condition, asset valuation, and compliance with various consumer related requirements.

57 Fed. Reg. 58732, 58739 (Dec. 11, 1992).

- Has or will seek to obtain advances comparable to the total asset size of the captive; and
- May experience a deterioration in its financial condition.[14]

We have found no authority for such FHLB membership criteria. Indeed, the Captive Proposal would establish an irrebuttable determination that each current captive member, each current captive applicant, and each potential captive applicant would trigger the Special Captive Ineligibility Criteria and be ineligible for membership.

Such an approach by the FHFA is neither consistent with, nor condoned by, section 4(a) of the FHLB Act, which:

- Does not condition insurance company membership eligibility on the purpose or activities of the insurance company;[15]
- Does not determine the level of advances that the member may seek relative to its asset size;[16] and
- Does not condition membership on the future financial condition of the insurance company.[17]

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14 In this regard, the Captive Proposal sets forth two closely overlapping financial condition-related concerns regarding captive insurance companies. The first is that a captive's financial condition could worsen without the knowledge of the FHLB and the second is that a captive's financial condition could deteriorate. For purposes of this letter we have combined these two concerns. Proposal at 54854.

15 Presumably, any analysis of the activities or objective of an insurance company was subordinated to the simple standard set forth in the statute that it be organized under state law and regulated as an insurance company by a state insurance regulator.

16 The FHLB Act separately establishes the requirements for advances to members, including a requirement that advances be fully secured and the types of collateral that may be used to secure advances. 12 U.S.C. § 1430. The FHLB Act expressly allows a member to pledge assets of an affiliate to secure advances to the member, thus permitting resources beyond those directly held by the member to be used to secure a member's borrowings from the FHLB. 12 U.S.C. § 1430(e); 12 C.F.R. § 1266.7(g). Moreover, an FHLB is given broad authority to apply its credit underwriting standards to decide whether to limit or deny advances to a particular member. 12 C.F.R. § 1266.4.

17 The Safety and Soundness Requirements call for a case-by-case evaluation of the financial condition of a particular prospective member only at the time it seeks to become a member of an FHLB. Once an entity becomes an FHLB member, FHLBs routinely monitor the financial condition of members and obtain financial information regarding members as part of their ongoing credit underwriting process. FHFA regulations expressly provide that an FHLB may make advances or renewals of advances only if the FHLB determines that it may safely make advances or renewals to a member. 12 C.F.R. § 1266.4(a)(2). Similarly, there are restrictions on advances to capital deficient members or members without positive tangible capital. 12 C.F.R. § 1266.4(b)-(e).

The Captive Proposal completely treats as non-existent the extensive underwriting and collateral protection techniques used by the FHLBs to ensure that FHLBs are fully protected against the deterioration of a

These factors are simply not related to the Housing Finance Requirements or the Safety and Soundness Requirements.

Nothing in the express language of the FHLB Act indicates that Congress intended to exclude ***any*** type of insurance company that meets the requirements of the statute from becoming a member of an FHLB.

Between 1932 and today, Congress could have easily conditioned insurance company membership based on the lines of insurance that the company writes. It has not. Nor has Congress conditioned insurance company membership based on the identity of the company's insured customers. It has never created any of these distinctions because it was trying to promote housing finance liquidity, not draw arbitrary lines about who could create it. We take Congress's words at face value – ***any*** insurance company is eligible for potential membership.[18] Accordingly, the FHFA does not have the administrative authority to repeal that provision of the law.[19]

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member's financial condition. The failure to mention how the FHLBs limit advances, monitor the financial health of their members, overcollateralize advances, calculate the value of collateral on a continuing basis and physically take possession of the collateral of captive insurance companies underscores that the FHFA's Captive Proposal should be completely reevaluated.

18 It is a well recognized principle of statutory construction that "read naturally, the word 'any' has an expansive meaning, that is, 'one or some indiscriminately of whatever kind.'" *New York v. E.P.A.*, 443 F.3d 880, 885 (D.C. Cir. 2006), quoting *United States v. Gonzales*, 520 U.S. 1, 5 (1997). *See also Financial Planning Ass'n v. SEC*, 482 F.3d 481, 488 (D.C. Cir. 2007) ("The word 'any' is usually understood to be all inclusive.").

19 Under *Chevron, U.S.A., Inc. v Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984), the validity of an agency rulemaking is evaluated under a two step test. First, a court must determine whether Congress has directly spoken to the precise question at issue. "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842-43. Second, "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Id.* at 843.

Here the intent of Congress is clear and unambiguous. ***Any*** insurance company that is organized under state or federal law and that is regulated as an insurance company by a state insurance regulator is eligible for membership in an FHLB. Under the principles of *Chevron*, the FHFA may not seek by regulation to adopt an approach that is indisputably contrary to the intention of Congress by redefining an "insurance company" to exclude certain insurance companies from eligibility to be FHLB members. The FHFA seeks to avoid the application of the first prong of *Chevron* by asserting that the absence of a definition of the term "insurance company" in the FHLB Act gives it the authority to define the term by regulation. As described above, we believe the intent of Congress regarding the unrestricted range of insurance companies eligible for FHLB membership is clear and unambiguous.

The FHFA's assertion that the absence of a definition of the term "insurance company" in the FHLB Act leaves the agency free to define the term by regulation is directly at odds with a decision of the U.S. Court of Appeals for the District of Columbia Circuit in a similar context. In that case the Securities and Exchange Commission argued that the absence of a definition of the term "clients" in a provision of the

Simply put, Congress established the requirements for FHLB membership in section 4(a) of the FHLB Act. The FHFA cannot on its own initiative usurp legislative prerogatives and establish new and different eligibility requirements that are not related to the Housing Finance Requirements or the Safety and Soundness Requirements. Accordingly, we believe that the Captive Proposal is fundamentally flawed and should be promptly withdrawn.

5.2.2. The Captive Proposal Is Contrary to Law By Asserting an FHFA Right to Terminate Membership

Similarly, the Captive Proposal purports to allow the FHFA to act by regulation to automatically terminate the membership of all captive insurance companies ("Existing Captive Member") five years after the effective date of a final rule. The FHFA also indicates that it intends to draft a final rule to provide for immediate termination of a captive member that becomes a member after the date of publication of the Captive Proposal ("New Captive Member"). As discussed further in section 6 below, these provisions are also contrary to law and the plain language of the statute. Congress expressly amended the FHLB Act to eliminate the authority of the FHFA to terminate the membership of any member of an FHLB. In doing so, Congress transferred the exclusive authority and discretion to do so to the board of directors of an individual FHLB.[20]

5.3. The Captive Proposal is Arbitrary and Capricious

The FHFA is required to operate within the requirements of the law, including the APA.[21] In that regard, the Captive Proposal, if adopted in its current form, is subject to being voided by a court because its rationale is arbitrary and capricious.[22]

Investment Advisors Act rendered the statute ambiguous as to a method for counting clients. A panel of the D.C. Circuit rejected this argument stating, "[t]here is no such rule of law." *Goldstein v. SEC*, 451 F.3d 873, 878 (D.C. Cir. 2006). The court explained that:

> [t]he lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous, just as the presence of a definition does not necessarily make the meaning clear. . . . If Congress employs a term susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose *any* one of those meanings. As always, the "words of the statute should be read in context, the statute's place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account" to determine whether Congress has foreclosed the agency's interpretation. *Id.* (quoting *PDK Labs, Inc. v. DEA*, 362 F.3d 786, 796 (D.C. Cir. 2004)).

20 12 U.S.C. § 1426(d)(2)(A).

21 5 U.S.C. §§ 551 *et seq.*

22 5 U.S.C. § 706(2)(A).

First, it would expel all captive insurance companies from FHLB membership by creating Special Captive Ineligibility Criteria, which are not part of or consistent with the FHLB Act.

Second, it would categorically exclude all captives regardless of whether a particular captive exhibits any of the features that the FHFA purports to find objectionable.

Third, it would expel all captive insurance companies on bases that are not relevant to the actual application of Congress's membership eligibility requirements, all of which can be addressed, to the extent that they are not already addressed by the FHLB Act, FHFA regulations and the FHLBs, in less onerous and less punitive ways.

Fourth, there is no indication that the FHFA engaged in an evaluation of the costs and benefits of the Captive Proposal or alternative approaches that could better balance those costs and benefits.

5.3.1. The Captive Proposal Would Arbitrarily and Capriciously Blacklist Captive Insurance Companies

The blanket exclusion of captive insurance companies is not consistent with the membership criteria that are set forth in the FHLB Act. None of the grounds identified by the FHFA to support its proposal to exclude captive insurance companies – the Special Captive Ineligibility Criteria – are set forth in or supported by the provisions of section 4(a) of the FHLB Act.

While the FHFA has authority to interpret and flesh out the statutory requirements established by Congress in the FHLB Act, section 4(a) of the FHLB Act does not: (i) bar membership based on the identity of a prospective member's affiliates, (ii) regulate the funds that a member may provide to its affiliates, (iii) limit the amount of advances relative to a prospective member's asset size, or (iv) restrict membership based on the future financial condition of a member when establishing an applicant's eligibility for membership. The law focuses on enhancing mortgage credit liquidity and doing so in an economically sound fashion. The application of these factors in the way done in the Captive Proposal is arbitrary and capricious.

5.3.2. The Lack of Empirical Data to Support the Solution Underscores the Arbitrariness of the Proposal

The Captive Proposal does not provide any empirical data regarding how many, if any, captive insurance companies exhibit any of the Special Captive Ineligibility Criteria. Neither does it indicate how many of these criteria a captive insurance company would have to exhibit in order to merit ineligibility for FHLB membership.

However, under the terms of the Captive Proposal, these striking deficiencies appear to be of no consequence. As the Captive Proposal is structured, it does not make any difference whatsoever, how many, if any, of the Special Captive Ineligibility Criteria a particular captive insurance company might be deemed to exhibit. Even if a captive insurance company did not exhibit any of the Special Captive Ineligibility Criteria, it would still be excluded from FHLB membership simply because it was a captive insurance company.

In sum, the approach set forth in the Captive Proposal is a classic example of a result-oriented action, which is not supported by the facts, and no analytical rationale is provided.[23] That is the definition of an arbitrary and capricious rule under the law.[24]

5.3.3. The FHFA Failed to Consider Less Onerous Regulatory Options

The arbitrary and capricious nature of the Captive Proposal is further demonstrated by the many options that the FHFA did not consider to address in its stated concerns. As discussed in section 5.2.1 above, the FHLB Act, FHFA regulations and FHLB policies comprehensively address safety and soundness related considerations regarding FHLB relationships with their captive insurance company members. FHLBs enjoy a high level of protection in their advances to captive insurance companies. Advances to such members must be fully secured by acceptable collateral.[25] As a practical matter, many FHLBs may take possession of collateral provided by their insurance company members, including captive insurance company members.[26]

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23 While the Proposal would subject all captive insurance companies, regardless of their status under the Special Captive Ineligibility Criteria, to expulsion from the FHLB System, completely different treatment would apply to all other members and potential members of FHLBs that are not captive insurance companies ("Other Entities"). Under the Proposal, the membership eligibility of any Other Entity would be completely unaffected even if the Other Entity were deemed to exhibit all three of the Special Captive Ineligibility Criteria, while a captive insurance company that exhibited none of the Special Captive Ineligibility Criteria would be prohibited from FHLB membership. Such an unjustified difference in treatment would plainly be arbitrary and capricious.

24 *See Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 43, 103 S. Ct. 2856, 77 L. Ed.2d 443 (1983) ("Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.").

25 The FHFA recently provided guidance to FHLBs on credit risk management practices to ensure that FHLB advances remain fully secured when lending to insurance company members. FHFA Advisory Bulletin 2013-09 (Dec. 23, 2013).

26 *See* FHLB Des Moines Form 10-Q for the quarter ended June 30, 2014 at 72; FHLB Indianapolis Form 10-Q for the quarter ended June 30, 2014 at 56; FHLB New York Form 10-Q for the quarter ended June 30, 2014 at 17-18; FHLB San Francisco Form 10-Q for the quarter ended June 30, 2014 at 87; FHLB Seattle Form 10-Q for the quarter ended June 30, 2014 at 61-62.

Furthermore, in some instances an FHLB may require a parent company guarantee of a captive insurance company's obligations to the FHLB.[27]

If the FHFA is concerned that FHLB members are (i) receiving advances that are too large of a percentage of a member's total asset size, (ii) passing along too much of the advances that they receive to affiliates, or (iii) susceptible to future financial deterioration,[28] and it has a valid basis for these concerns, it could seek to address these concerns through an amendment to its rules governing the making of advances, which would apply to all members.[29] Defaulting to a wholesale exclusion of companies that are statutorily authorized for FHLB membership is neither appropriate nor legal.

5.3.4. The FHFA Failed to Conduct a Cost-Benefit Analysis in Regard to the Captive Proposal

In July 2011, President Obama issued Executive Order 13579[30] which urged independent regulatory agencies, including the FHFA, to comply with Executive Order 13563 ("EO 13563").[31] EO 13563 sets forth principles for federal rulemaking by executive branch agencies and, among other things, calls for agencies: (i) to propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs; (ii) to tailor regulations to impose the least burden on society, consistent with obtaining regulatory objectives; and (iii) to choose among alternative approaches by taking approaches that maximize net benefits.

There is nothing in the Captive Proposal to indicate that the FHFA has heeded the President's order. The Captive Proposal does not contain any cost-benefit analysis.

The absence of a cost-benefit analysis is particularly problematic in the context of the Captive Proposal. Under the Captive Proposal, captive insurance companies that fully satisfy the

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27 *See* FHLB Indianapolis Form 10-Q for the quarter ended June 30, 2014 at 56. The FHFA apparently ascribes bad motives to the willingness of parent entities to provide guarantees for subsidiary captive insurance companies, attributing such actions to a desire to utilize the captive as a conduit vehicle. Proposal at 54854. Parent company guarantees of subsidiary obligations are neither unusual nor inherently suspicious. The FHFA would presumably welcome an additional source of financial protection for advances to an FHLB member.

28 As noted, the FHLBs effectively underwrite these risks today. We suggest that the efficacy of such underwriting standards employed by the FHLBs should be judged on their financial results – millions of Americans have been able to finance their homes and no FHLB has ever suffered a loss on advances to any member.

29 12 C.F.R. Part 1266.

30 76 Fed. Reg. 41587 (Jul. 14, 2011).

31 76 Fed. Reg. 3821 (Jan. 21, 2011).

Housing Finance Requirements and the Safety and Soundness Requirements will be cut off from access to FHLB advances, which they would otherwise have the ability to deploy to provide liquidity to the housing finance market. If the FHFA did not evaluate the costs to the economy and society associated with expelling current captive insurance companies from membership and participation in the FHLB System, it cannot make a reasonable determination on how to proceed. If it did do such an analysis, but did not disclose it, the public cannot meaningfully comment if the FHFA does not fully explain what it analyzed, what the results were and how they would impact interested parties and the economy in general.

The FHFA similarly has not provided any empirical evaluation of the benefits of the Captive Proposal. It has presented no evidence that creating a blacklist of captive insurance companies would provide any benefit to the economy or society. It offers no suggestion that the membership of captive insurance companies in FHLBs has caused any loss to an FHLB, or has presented any safety and soundness concerns with respect to any FHLB.

The purpose of a cost-benefit analysis, as set forth in EO 13563, is to ensure that regulatory agencies recognize and consider the impact and consequences of their regulatory actions. In this instance, current and prospective captive insurance company members would be excluded from participating in the housing finance facilities provided by FHLBs. Thus, the Captive Proposal on its face will impose costs by reducing the number of institutions that would be providing the housing finance benefits associated with FHLB membership. At the same time, the Captive Proposal does not identify or quantify any specific benefits associated with the exclusion of captive insurance companies from FHLB membership. Under EO 13563, such an imbalance between costs and benefits should cause an agency to look for less costly alternative approaches, which are clearly available in this case.

A fundamental failure to evaluate, weigh and disclose the costs and benefits of a proposed regulation and to ignore alternative approaches is not only at odds with EO 13563, it is the mark of a regulation that is arbitrary and capricious.

5.3.5. The Captive Proposal Is Inconsistent with Public Policy Encouraging Private Sector Participation in Housing Finance

The Captive Proposal would expel Existing Captive Members. It would also seek to discourage New Captive Members in the short term and prohibit New Captive Members in the longer term. The impact of the Captive Proposal would be to prevent private sector capital associated with captive insurance companies from participating in a vehicle that Congress has established and maintained as a critical element of housing finance liquidity for over eight decades.

Action by the FHFA to restrict private sector participation in the FHLB System is directly contrary to the approach that Congress has taken in expanding rather than contracting eligibility

for FHLB membership. As discussed above, ***any*** insurance company has been eligible for FHLB membership since the day that the FHLB Act was enacted. In 1989, Congress dramatically expanded eligibility for FHLB membership by allowing FDIC insured depository institutions and National Credit Union Share Insurance Fund insured credit unions to become members.[32] In 2008 Congress again expanded FHLB membership by allowing community development financial institutions to become members.[33]

Congress is currently considering the future of the housing finance sector. In that regard, the Senate Committee on Banking, Housing and Urban Affairs on September 18, 2014, reported S. 1217 the Housing Finance Reform and Taxpayer Protection Act of 2013 for consideration by the full Senate. S. 1217 seeks to encourage and enhance private sector participation in the housing finance sector by, among other things, establishing new public-private sector relationships in regard to the offering of mortgage-backed securities.[34]

On October 21, 2014, the FHFA joined with other federal agencies ("Agencies") in adopting final rules implementing the risk retention provisions contained in section 941 of the Dodd-Frank Act ("Risk Retention Rule"). The FHFA participated in the portion of the Risk Retention Rule related to residential mortgage assets. The Agencies decided to align the qualified residential mortgage provision of the Risk Retention Rule with the qualified mortgage provision adopted by the Consumer Financial Protection Bureau under another section of the Dodd-Frank Act. In explaining this decision, the Agencies, including the FHFA, stated that they believe that their action "will help promote access to affordable credit by minimizing additional regulatory burden and compliance and *facilitating the return of private capital to the mortgage market*."[35]

These actions of Congress and leading federal regulatory agencies demonstrate that public policy supports private sector capital participation in housing finance. At a time when federal regulators are emphasizing the importance of encouraging a return of private sector entities to the housing finance market, the Captive Proposal inappropriately and unjustifiably moves in the opposite direction.

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32 12 U.S.C. § 1424(a)(1).

33 *Id.*

34 *See* Press Release, U.S. Senate Committee on Banking, Housing and Urban Affairs, Senate Banking Committee Passes Bipartisan Housing Finance Reform Legislation (May 15, 2014).

35 Office of Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities and Exchange Commission, Department of Housing and Urban Development, Credit Risk Retention Final Rule at 358 (Oct. 21, 2014) (emphasis added).

6. The FHFA Is Not Authorized to Terminate the Membership of an FHLB Member

The Captive Proposal provides that "[a] Bank shall terminate the membership of any captive that has remained a Bank member pursuant to paragraph (c)(2)(i) of this section as of [DATE FIVE (5) YEARS AFTER THE EFFECTIVE DATE OF THE FINAL RULE], as provided under § 1263.27."[36] The preamble to the Captive Proposal states that in the case of a New Captive Member, the FHFA would require the immediate termination of a New Captive Member's membership and prompt liquidation of any outstanding advances to the New Captive Member upon adoption of the final rule.[37]

The Captive Proposal is invalid as contrary to law on this basis alone. Under section 6(d)(2) of the FHLB Act, the FHFA has no authority to mandate the termination of a member. But that would be the precise effect of the Captive Proposal, which by its terms requires the board of directors of an FHLB to terminate the membership of an Existing Captive Member or a New Captive Member, as of a specified date.[38]

6.1. The FHLBs Have Exclusive Authority Over Involuntary Member Terminations

Prior to the enactment of the Gramm-Leach-Bliley Act ("GLB Act") in 1999, the FHFB had the authority to terminate membership in a FHLB.[39] However, section 6(d)(2)(A) of the FHLB Act as amended by the GLB Act expressly withdrew that authority:

> The *board of directors of a Federal home loan bank* may terminate the membership of any institution if, subject to the regulations of the Director, it determines that –

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36 To be codified at 12 C.F.R. § 1263.6(c)(2)(ii). Proposal at 54874.

37 Proposal at 54858.

38 In this regard, the FHFA would also be usurping the authority provided by section 6(d)(2) of the FHLB Act to the FHLBs boards of directors.

39 Prior to the enactment of the GLB Act, section 6(e) of the FHLB Act provided in part:

> the [FHFB] may, after hearing, remove any member from membership, if in the opinion of the [FHFB], such member (i) has failed to comply with any provision of this chapter or regulation of the [FHFB] made pursuant thereto; (ii) is insolvent . . . or (iii) has a management or home-financing policy of a character inconsistent with sound and economical home financing or with the purposes of this chapter.

> (i) the member has failed to comply with a provision of this chapter or any regulation prescribed under this chapter; or
>
> (ii) the member has been determined to be insolvent, or otherwise subject to the appointment of a conservator, receiver, or other legal custodian, by a Federal or State authority with regulatory and supervisory responsibility for the member. (*Emphasis added*).

The FHFB's regulation implementing the amendments to section 6(d)(2) of the FHLB Act leaves no doubt that the GLB Act divested the FHFB (and its successor, the FHFA) of any authority to mandate the involuntary termination of membership of an FHLB member.[40]

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[40] The FHFB discussed this topic in the preamble to the regulation:

> Prior to the GLB Act, section 6(e) of the Bank Act provided the Finance Board with the authority to terminate the membership of an institution that became insolvent . . . . Pursuant to that authority, the Finance Board adopted § 925.28(a), which provides that the membership of an institution placed in receivership (which in all likelihood would be insolvent) automatically terminates . . . . As discussed above, the GLB Act amended the Bank Act *by vesting in the Banks, rather than the Finance Board, the authority to determine whether to terminate involuntarily the membership of an institution that is insolvent or placed into receivership* . . . . One Bank suggested that the final rule retain the automatic termination provision in existing § 925.28 because that procedure has worked well and the proposed change would impose operational burdens on the Banks and receivers and conservators. The Finance Board has not implemented that recommendation in the final rule, *because the GLB Act vests the authority for making such decisions in the board of directors of each Bank, rather than in the Finance Board.* Thus, if a member is placed into receivership or conservatorship or otherwise is determined to be insolvent, the board of directors of each Bank must determine whether it is most appropriate to allow the institution to remain a member of the Bank for some period of time or to terminate its membership under these provisions.

66 Fed. Reg. 8262, 8270-71 (Jan. 30, 2001) (emphasis added).

Accordingly, section 1267.27(a) of the FHFA's regulation regarding involuntary membership termination provides:

> (a) *Grounds.* The board of directors of a Bank may terminate the membership of any institution that:
>
> (1) Fails to comply with any requirement of the Bank Act, any regulation adopted by the FHFA, or any requirement of the Bank's capital plan;
>
> (2) Becomes insolvent or otherwise subject to the appointment of a conservator, receiver, or other legal custodian under Federal or State law; or
>
> (3) Would jeopardize the safety or soundness of the Bank if it were to remain a member.

In the Proposal, the FHFA appears to rewrite the FHLB Act and repudiates the FHFB's understanding of the intent of Congress in enacting section 6(d)(2) of the FHLB Act, reinserting itself into a decision that Congress shifted away from the FHFA and reserved to the boards of the FHLBs.[41]

The FHFA asserts that its mandate for involuntary termination "is appropriate where, as here, the regulatory violation is not of just any provision of the Bank Act or FHFA regulations, but of the very regulation that defines eligibility for membership, the purpose of which would be defeated if membership were allowed to continue."[42] In effect, the FHFA is saying that the importance of its objective of terminating the membership of captive insurance companies justifies its effort to terminate their membership in a manner that is not permitted under the FHLB Act. This does not, however, support the FHFA's right to adopt a rule that is contrary to law.

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41 The FHFA tries to do so by explaining that the use of the word "may" in section 6(d)(2)(A) of the FHLB Act:

> indicates that Congress intended to permit a Bank a degree of discretion in deciding when it must terminate an institution's membership, but it does not vest in a Bank unlimited discretion to decide when to exercise that authority, as is evidenced by the accompanying language that a Bank's termination authority is "subject to regulations of the Director."

Proposal at 54868.

The FHFA asserts that the reference to a board of directors of an FHLB exercising its discretion in regard to an involuntary termination *subject to the regulations of the FHFB* allows the FHFA to adopt a regulation that specifies the circumstances in which an ongoing violation of law requires an FHLB to exercise its termination authority.

The phrase "subject to the regulations of the Director" is not a legitimate basis for overturning the express statutory amendments that Congress made in the GLB Act. Nothing in the plain language of the statute supports an argument that the reference to regulations of the Director is intended to allow the FHFA to usurp the discretion of a board of directors of an FHLB and mandate a termination decision. The plain language of section 6(d)(2) of the FHLB Act indicates that it means exactly what the FHFB did in adopting section 925.27 of its regulations following the enactment of the GLB Act. Section 925.27, which is now codified at section 1267.27 of the FHFA's regulations, addresses (i) the grounds for discretionary involuntary termination of a member by a board of directors of an FHLB, (ii) the stock redemption periods for capital stock held by an involuntarily terminated member, and (iii) the membership rights of an involuntarily terminated member.

These regulations appropriately and logically relate to the exercise of a FHLB board of directors' discretion to involuntarily terminate a member's membership under certain circumstances and the consequences of such a termination. They do not seek to overturn the plain meaning of section 6(d)(2) nor purport to authorize the FHFA to mandate involuntary termination of a member.

42 Proposal at 54868.

7. The Captive Proposal Would Give Rise to Potential Claims Against the United States for the Taking of Private Property, and There Is Nothing in the FHLB Act to Suggest that Congress Intended to Give the FHFA Authority to Effect Such a Taking

As the D.C. Circuit has held, no federal agency may adopt an administrative rule that would give rise to a takings claim against the U.S. Treasury unless Congress has clearly authorized the agency to do so by statute.[43] There is nothing in the FHLB Act that remotely suggests that Congress intended to authorize the FHFA to effect a taking of members' property interests by forcing them to surrender their shareholdings in FHLBs. Because the Captive Proposal would purport to do just that, it exceeds the statutory grant of authority to the FHFA and would likely be struck down by a reviewing court on this ground, as well.

Under the FHLB Act, members of an FHLB that hold Class B stock, including the captive insurance companies affected by the Captive Proposal, have a pro rata property interest in the retained earnings, surplus, and undivided profits of the FHLB.[44] In addition, membership in an FHLB and the holding of capital stock therein entitle a member to access the products and services offered by the FHLB to its members. In particular, this right held by members includes the right to access FHLB advances, which are generally available at favorable rates and terms to members. If captive insurance companies are forced to forfeit these property rights through no fault of their own under the FHFA's Captive Proposal, they will suffer a monetary loss that would not be adequately compensated by the receipt of par value for their FHLB stock.

Captive insurance companies that hold stock in an FHLB, like all FHLB members, understand that their property interest in continuing membership is subject to the proper exercise of the discretion granted to FHLB boards of directors under the FHLB Act to uphold membership standards and to terminate an individual member on a case-by-case basis where the board determines that the member has failed to meet those standards. But when they acquired their stock, these members could have no reason to expect that the FHFA might attempt to expel from membership by rule an entire category of stockholders otherwise satisfying all applicable standards enforced by FHLB boards and being long recognized as eligible for membership.

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43 *See Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441, 1445-46 (D.C. Cir 1994) (declining to apply *Chevron* deference to an FCC order that purported to require local telephone companies to give competitors physical access to their network facilities). The D.C. Circuit in *Bell Atlantic* adopted a "narrowing construction" of the Communication Act because the agency's interpretation created an "identifiable class" of applications that would "constitute a taking" requiring just compensation under the Fifth Amendment. *Id.* at 1445-46 (quoting and applying *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 127-28 & n.5 (1985)).

44 12 U.S.C. § 1426(h)(1).

If captive insurance companies suffer an inadequately compensated taking of property interests as a result of the forced expulsion from FHLB membership ordered by the FHFA, the expelled members would have a potential claim for damages against the United States in the Court of Federal Claims.[45] Because no provision of the FHLB Act even remotely (let alone clearly) grants the FHFA authority to cause such a taking of private property and to create such liability for the U.S. Treasury under the Fifth Amendment, the Captive Proposal exceeds the FHFA's statutory powers and would represent arbitrary and capricious rulemaking.

8. Conclusion

For the reasons set forth above, we respectfully urge the FHFA to promptly withdraw the Captive Proposal.

We appreciate your consideration of our comments.

Sincerely,

Thomas P. Vartanian

45 *See United States v. Winstar*, 518 U.S. 839 (1996).