November 4, 2014

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Re: *RIN 2590-AA 39 – Proposed Rulemaking Regarding Membership Requirements in the Federal Home Loan Bank System*

Dear Mr. Pollard:

Invesco Mortgage Capital Inc. (referred to herein as "IVR," "we" or "the Company") is a New York Stock Exchange listed mortgage real estate investment trust ("MREIT") whose target assets consist of residential and commercial mortgage-backed securities ("MBS") and mortgage loans. As of September 30, 2014, IVR had consolidated total assets of approximately $21.0 billion. We are externally managed and advised by Invesco Advisers, Inc., a registered investment adviser and an indirect, wholly-owned subsidiary of Invesco Ltd., a leading independent global investment management firm. One of the company's wholly-owned subsidiaries, IAS Services LLC ("IAS Captive"), is a Michigan pure captive insurance company and member in good standing of the Federal Home Loan Bank of Indianapolis ("FHLBI"). IAS Captive holds approximately $2.3 billion of residential and commercial MBS, and to date has secured advances with FHLBI with an aggregate principal amount outstanding of $1.25 billion.

We are responding to a request for comments on the Notice of Proposed Rulemaking and Request for Comments – Members of Federal Home Loan Banks (RIN 2590-AA39) ("Proposed Rule") submitted by the Federal Housing Finance Agency ("FHFA").[1] The primary focus of our letter will address the FHFA's proposal to eliminate captive insurance companies from Federal Home Loan Bank ("FHLB") membership. FHFA's stated purpose for the Proposed Rule is to revise the membership regulation to implement more effectively the statutory eligibility requirements to ensure that FHLB members meet the mission of the FHLB and do not threaten the safety and soundness of the FHLB system.

We believe the adoption of the Proposed Rule would undermine the mission of the FHLB and adversely affect the mortgage market and homeowners. In addition, the Proposed Rule inappropriately excludes an otherwise eligible member of the FHLB system (as provided for in the governing statute) and attempts to address safety and soundness concerns that are not unique to captive insurance companies and are already effectively dealt with by the FHLB system. Finally, we believe the Proposed Rule contravenes the intent of the Federal Home Loan Bank Act of 1932 (the "Bank Act") and exceeds FHFA's rulemaking authority.

[1] 79 Fed. Reg. 54848 (Sept. 12, 2014).

The Bank Act and the Mission of the Federal Home Loan Bank System

The Bank Act created the Federal Home Loan Bank system to provide previously unavailable liquidity in the form of advances against residential mortgage loan collateral to eligible members to help alleviate the ongoing mortgage crisis. Since then, the FHLB system's role in providing liquidity has only expanded by amendments to the Bank Act that have always broadened the scope of the FHLB's membership and mission.

Insurance companies have been eligible members of the FHLB system since the Bank Act's adoption in 1932 (over 80 years). At that time, insurance companies were significant national lenders in the residential mortgage market, as compared to more locally focused Building and Loan Savings Associations that were suffering from a liquidity crisis. We note that captive insurance companies have been members of the FHLB system in good standing for over twenty years. Congress has had the opportunity to specifically limit the membership of the FHLB system to certain types of insurance companies during this period and has declined to do so, despite multiple amendments to the Bank Act, as well as the FHFA highlighting the same issues in a 2010 Advanced Notice of Proposed Rulemaking, during this period.[2] Instead, Congress has done the opposite and only expanded eligible membership and the mission of the FHLB system. For example, membership now includes commercial banks, thrifts, credit unions and community development financial institutions, as well as the originally eligible members of building and loan associations, insurance companies and insured depository institutions. In addition, in 2008, Congress explicitly recognized the FHLB's mission of providing liquidity to members without limiting that purpose to housing finance, highlighting a dual mission of "providing liquidity to members" and supporting "affordable housing and community development."[3] Expanded membership supports the expanded mission of the FHLB.

Mortgage REIT Captive Insurance Companies Support the Mission of the FHLB

Mortgage REITs and their related captive insurance companies fulfill the mission of the FHLB to support communities across the United States by providing much needed long-term private capital to the residential mortgage market. Recently released data from the Federal Reserve demonstrates the sizable impact MREITs have had in support of the residential mortgage market. As of June 30, 2014, MREITs hold approximately $545 billion in mortgages and mortgage-related securities, or approximately 5.5% of the residential mortgage market.

Long-term private capital provided by MREITs and their related captive insurance companies will be critical to the functioning of the U.S. government's goal of the future state of the residential mortgage market. As a result of the financial crisis that began in 2008, Fannie Mae and Freddie Mac were placed into U.S. government conservatorship. Currently, these government-sponsored entities ("GSEs") are in the process of winding down their portfolios through amortization and asset sales. In addition, the Federal Reserve has recently completed its purchases of mortgage-backed securities under

[2] *See* 75 FR 81145 (Dec. 27, 2010).

[3] The Housing and Economic Recovery Act of 2008 ("HERA"), Pub. L. 110-289 § 1201, 122 Stat. 2654 (2008), codified at 12 U.S.C. § 4513. Bank Act amendments in 1989 and 1999 also expanded the FHLB's eligible membership and mission through the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Pub. L 101-73 § 709, 013 Stat. 183, 12 U.S.C. § 1424 (1989)) and Gramm-Leach-Bliley Act of 1999 (Pub. L. 106-102 § 604, 113 Stat. 1338, 12 U.S.C. § 1430 (1999)).

its quantitative easing program and is considering alternatives for reinvestment of proceeds from current holdings. For the first time in many years, the U.S. Government and related entities will not be supporting the mortgage market through purchases. Additionally, the potential for them to become a net seller exists, as the Federal Reserve unwinds its balance sheet.

Since the GSEs were placed in conservatorship, MREITs and their related captive insurance companies have emerged as efficient vehicles for accessing the capital markets and deploying private funds into the residential mortgage sector in a variety of forms, fully supporting the mission of the FHLB system. MREITs and their related captive insurance companies have furthered housing affordability for consumers by originating mortgage loans, purchasing mortgage-backed securities, providing first loss capital for new private label securitizations, and owning and financing rental housing. These mortgage market participants have also purchased a large portion of the credit risk transfer securities recently issued by the GSEs. MREITs' investment in such assets has been a key component of the FHFA's initiative to reduce taxpayer risk in the residential mortgage market. In addition, we estimate that MREITs have sponsored or taken first loss positions in at least 75% of private label securitizations issued since the beginning of 2013. In the future, MREITs and their related captive insurance companies are likely to play a major role in serving those borrowers who are not able to meet the requirements of the Qualified Mortgage rule. Thus, MREITs and their related captive insurance companies are currently significant supporters of the U.S. residential mortgage market and the mission of the FHLB and will be important providers of private capital consistent with the U.S. government's stated goal of a residential mortgage market less reliant on government support.

The Proposed Rule Adversely Impacts the Housing Recovery

The FHFA's Proposed Rule to eliminate FHLB membership for captive insurance companies operated by responsible mortgage market participants limits the ability of these firms to support affordable credit for prospective homeowners. Although FHLB funding to MREIT captive insurance companies is not presently a significant component of consolidated MREIT financing, it is an avenue for growth of stable funding at reasonable terms. If the FHFA enacts the Proposed Rule, there will be reduced availability of stable financing for investments for current members of the FHLB system as well as those seeking admission, which may further limit the number of firms dedicated to supporting the market for residential mortgages. A relative tightening of credit for homebuyers would also adversely impact new home construction, which otherwise has the potential to be a major contributor to economic growth and employment gains given depressed levels of construction activity since the crisis. In short, the withdrawal of liquidity threatened by the Proposed Rule would hinder the housing recovery.

We believe the ongoing membership tests proposed by the FHFA will have a similar stifling effect. These proposed membership tests (requiring all FHLB members to maintain 1% to 5% of assets in home mortgage loans and require non-CFI depository institutions to maintain 10% of assets in home mortgage loans) are arbitrary and without basis in the Bank Act. Although we do not expect the proposed ongoing eligibility requirements would affect the manner in which IAS Captive conducts its business or its membership eligibility, we are concerned with this aspect of the Proposed Rule as an FHLB member and significant mortgage market participant.

These membership requirements could hinder sound balance sheet management (particularly in times of financial stress with mortgage valuation instability) and disadvantage seasonal community

lenders and mortgage banks that sell mortgage production. Further, these proposed requirements fail to recognize that members, including captive insurance companies, may from time to time sell their mortgage holdings into the secondary market. In addition, the proposed ongoing eligibility tests are unnecessary as the existing FHLB collateral policies (discussed below) ensure support of the FHLB system mission and that members are participating in the mortgage market at significant levels. Whenever any member seeks an advance from an FHLB, it must provide "eligible collateral," which is determined by statute, representing a mechanism put in place by Congress to ensure that advances were appropriate for the FHLB system's goals. The FHFA proposes to inject arbitrary limitations and disincentives to FHLB membership and uncertainty into the system even though, as it notes, "FHFA has found no evidence that this problem [of institutions having only minimal home mortgage loan assets and no plans to originate or purchase any significant amounts of such assets] is widespread."[4]

Restricting FHLB membership through the FHFA's newly-proposed eligibility requirements, including the elimination of a class of members permitted by the Bank Act, inhibits the ability of the FHLB system to profit from its relationships with insurance companies and other eligible members, ultimately limiting the ability of FHLBs to support affordable housing through that portion of the FHLBs' earnings. Monitoring ongoing eligibility requirements would require FHLB member banks to move from a lending role to that of a regulator, imposing additional operational costs on the FHLB system. Breadth of membership and participation are key components of the FHLB system that allow it to provide products and services to advance the FHLB goals of market liquidity and affordable housing. Adoption of the Proposed Rule requirements would fundamentally and negatively alter the relationship the FHLB system has with its members, may deter desired FHLB membership and ultimately reduce FHLB's earnings that could otherwise be used to support affordable housing. As such, adoption of the Proposed Rule would adversely affect the ability of the FHLB to meet its mission to support the housing market.

Captive Insurance Companies Are Insurance Companies (and Eligible Members of the FHLB System)

The FHFA has proposed the exclusion of captive insurance companies from membership from the FHLB system because it is concerned that "in some cases the primary, or sole, motivation for those captives has been to become members in order to serve as a funding conduit through which a parent or affiliate of the captive, which is not itself eligible for Bank membership, may gain access to Bank advances."[5] The Bank Act's eligibility requirements ensure that FHLB members support the FHLB mission and the safety and soundness of the mortgage market. The statute requires that members be U.S. entities that support the mission of the FHLB (through its 'makes home mortgage loans' requirement) and are subject to inspection and regulation under the banking laws, or under similar laws, of the United States.[6] The Bank Act does not include restrictions on an FHLB member's use of proceeds, does not provide limitations on ownership of statutory eligible members and does not require that eligible members be "principally engaged" in a particular business. As we discuss further below, despite the absence of these restrictions in the statute, FHLBs have been extremely adept at managing its membership and loan program to support its housing mission, having never suffered a credit loss.

[4] Proposed Rule at 21.
[5] Proposed Rule at 24-25.
[6] 12 U.S.C. § 1424(a).

While the Proposed Rule would ban captive insurance companies from FHLB membership for acting as financing conduits, the FHFA recognizes other eligible members of the FHLB system may pass along the economic benefits of membership to their holding company parent or other affiliates, which may not themselves be eligible for membership.[7] The FHFA attempts to differentiate other eligible members, stating that operational requirements ensure those members will be "principally engaged" in their core business.[8] FHFA notes that it believes that any future instances in which an eligible member, including insurance companies, may function to an inappropriate degree as a conduit for its parent or affiliates could be addressed through FHFA's oversight and examination functions.[9] The Bank Act nowhere requires members be "principally engaged" in a particular business. The mission of the FHLB is to ensure a robust residential mortgage market – not to regulate the kinds or amounts of insurance or banking activity being engaged in by its members. As with other aspects of the Proposed Rule, we believe that the new limitations not only undermine the intent of the Bank Act, but may also discourage FHLB membership through increased cost of membership or uncertainty in the required operations of members, leading ultimately to adverse effects on the mortgage market.

Further, the FHFA's proposed exclusion of captive insurance companies as eligible members effectively declares state insurance laws and regulations, such as the Michigan Insurance Code of 1956 (the "Michigan Code"), inadequate to meet the "subject to inspection and regulation" standard imposed by the Bank Act. However, captive insurance companies are subject to rigorous inspection and regulation under state law, much the same as traditional insurance companies and in accordance with the requirements of the Bank Act. By way of example, IAS Captive is subject to the requirements of Chapter 46 of the Michigan Code as a pure captive insurance company. Under the Michigan Code, prior to approving the creation of the captive insurance company, the Commissioner of the Department of Insurance and Financial Services ("DIFS") must review and approve a plan of operation and investment policy, financial records, evidence of source and form of minimum capitalization, character and financial background on the organizers, and loss prevention program of the parent.[10] The Michigan Code also includes requirements related to corporate governance, principal place of business, and regulator inspection rights.[11] The captive insurance company is subject to annual reviews by the DIFS, which includes the annual submission to DIFS of audited financial statements and an opinion of an actuary analyzing the insurance program, as well as discretionary review by DIFS from time to time.[12] We also

[7] FHFA states that it "understands that it is possible for other types of institutions, including depository institutions owned by a bank holding company, to pass along the economic benefits of membership to their holding company parent or other affiliates, which may not themselves be eligible for membership." Proposed Rule at 26. *Compare*, Proposed Rule Comment Letter of Milton J. Miller II to Alfred M. Pollard, dated October 6, 2014, pg. 3, available at https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=12051, stating: "FHLBank insured depository members often have holding company or affiliate structures (*e.g.*, bank holding companies, investment or mortgage banking operating subsidiaries or affiliates), that are not eligible, by law, or for membership, yet these entities directly or indirectly benefit through the member's access to FHLBank credit products."

[8] Proposed Rule at 26.

[9] *Id*. We also note that other eligible members that may act as conduits for parent companies that are not eligible members may be a financing source to an entity that is not supporting the mission of the FHLB system in the same manner as MREITs.

[10] Michigan Code of 1956 § 500.4603.

[11] *Id.*

[12] *Id.*

note that the Michigan Code and related regulation provide limitations on dividends and other asset transfers out of the captive insurance company.[13]

Thus, the membership regulation requirements of the Bank Act for captive insurance companies are met by the oversight and supervision of the state insurance regulator. As discussed further below, additional regulatory oversight of the captive insurance company's parent and the policies of the FHLB provide additional support to the safety and soundness of the FHLB system. Captive insurance companies are insurance companies and meet the eligibility requirements of the Bank Act. As the statute is clear that insurance companies are eligible members, FHFA is exceeding its authority by rewriting an existing statute

The Proposed Rule Does Not Improve the Safety and Soundness of the FHLB System

The FHFA states in its Proposed Rule that captive insurance companies present safety and soundness concerns for the FHLB system beyond those presented by insured depository institutions and traditional insurance companies.[14] The FHFA notes that captive insurance companies present the risk of rapidly deteriorating financial condition due to the actions of its parent; the parent might decline to provide financial support, or to provide additional collateral, in cases of financial distress; and that the captive's balance sheet may reflect non-diversified risk if its underwriting activities are narrowly prescribed by the parent.[15] The FHFA also cites the "relative unavailability of objective financial information" as another example in which captive insurance companies insert additional risk into the FHLB system.[16]

However, FHLBs and their previous regulator have addressed similar issues in the exact opposite manner in which the FHFA proposes. The Federal Housing Finance Board ("FHFB") expressly permitted a member to pledge the collateral from a single purpose "captive" REIT subsidiary, formed solely for investment by the parent.[17] FHLBs have direct access to members that take advances, even if other parties are involved. 12 U.S.C. § 1430(d) requires that members applying for an advance "enter into a primary and unconditional obligation to repay" the advance.[18] The FHFB has stated that "as long as the member receiving the advance is primarily and unconditionally liable for repayment of the advance, it would not appear to be impermissible under the Bank Act and the Advances regulation for a non-member to be a party to the advances note, either without assuming liability, as assuming secondary or joint and several liability with the member."[19] Thus, the FHFB found one of the primary issues raised by the FHFA regarding captives to be covered by the statute: "by requiring the member receiving an advance to

[13] *Id.* § 500.4639.
[14] Proposed Rule at 26.
[15] Proposed Rule at 26-27.
[16] *Id.*at 26.
[17] *See* Housing Finance Board, Office of General Counsel (Mar. 16, 1998) (allowing an FHLB to accept a pledge of collateral from a REIT subsidiary of a member), *available at* http://www.fhfa.gov/SupervisionRegulation/LegalDocuments/Documents/FHFB-General-Cousnel-Opinions/1998/1998-GC-04.pdf.
[18] *See* FHFB, Letter of January 5, 1996, Paul Drolet, General Counsel, *available at* http://www.fhfa.gov/SupervisionRegulation/LegalDocuments/Documents/FHFB-General-Cousnel-Opinions/1996/1996-GC-01.pdf.
[19] *Id.* at 2.

be primarily obligated for repayment of the advance, the language of the Bank Act appears to contemplate the existence of secondary obligors on advances, sources other than the member."[20]

Moreover, these concerns cited by FHFA are issues that FHLBs adequately manage every day with every member, not just captive insurance companies. The Proposed Rule would result in significant changes to a well-functioning system (through rule-making) to fix a problem that does not exist – namely that the FHLB system has not effectively handled its membership and loan process to date. The FHLB has proven extraordinarily adept at managing its membership process and loan programs to support its housing mission, having never suffered a credit loss in its over 80-year history. Banks, insurance companies and other eligible members have faced the risk of rapidly deteriorating financial conditions through various economic cycles. These risks are addressed through the FHLB's membership eligibility and participation requirements discussed below. Through collateral policies, loan agreements and related documentation, FHLBs address the concerns raised by the FHFA that are applicable to all of its members in furtherance of supporting the safety and soundness of the system. All advances made are overcollateralized by eligible collateral. The FHLB system generally only accepts the highest quality residential loans as collateral, which also ensures member support of the FHLB mission. The collateral accepted by the FHLBs is not unique or individualized to depository institutions, insurance companies or captives. The FHLB system by its nature and mission accepts some level of risk to support its mission. The FHLB collateral eligibility requirements effectively preserve the safety and soundness of the system. In addition, FHLB agreements require transparent information reporting that allows FHLBs to closely monitor member advances and member financial condition. Further, FHLB custodial agreements include requirements for the provision of segregated collateral for the sole benefit of the FHLB.

Parent guarantees of captive insurance company obligations that may be required by FHLBs also bolster the safety and soundness of the system and the captive insurance company's participation in the FHLB system. Captive insurance companies' publicly-traded MREIT parents are subject to the rules and regulations of the Securities and Exchange Commission ("SEC") and the New York Stock Exchange, which require, among many other items, timely and transparent reporting of financial condition and material events affecting the MREIT. In addition, SEC disclosure requirements mandate that the publicly-traded MREIT disclose the material risks it is subject to, which we address extensively in SEC reports including IVR's Annual Report on Form 10-K. As such, the FHLB, as well as the public markets, are provided at least as much and possibly more financial information that is both timely and transparent, than other types of eligible members provide. In addition, two other regulatory frameworks encourage MREITs continued long-term participation in the mortgage market and support of the FHLB mission. IVR has elected to be taxed as a REIT, subject to specific requirements of the Internal Revenue Code of 1986, as amended, and operates its business in a manner that permits our exclusion from the definition of "investment company" under the Investment Company Act of 1940, both of which limit the kinds of assets in which IVR and its related captive insurance company may invest.

It is difficult to understand what problem unique to captive insurance companies the FHFA will remedy by excluding them from the FHLB system. Rather, we believe it will only serve to weaken a system that is otherwise strengthened by the participation of MREITs and their related captive insurance companies, which supply private capital needed to replace the role of government in mortgage finance.

[20] *Id.*

State insurance laws and regulations, the requirements of the FHLB system and the extensive regulatory regimes and oversight of a captive insurance company's public company parent, like IVR, meet the requirements of the Bank Act and adequately support the safety and soundness of the FHLB system.

The Proposed Rule Exceeds FHFA's Rulemaking Authority

We believe, as others have also argued,[21] that the Proposed Rule contravenes the intent of Congress and exceeds the FHFA's rulemaking authority. As previously discussed, insurance companies have been eligible members of the FHLB system since the adoption of the Bank Act. And, captive insurance companies are insurance companies and have been members in good standing for over twenty years. It is notable that the Bank Act does not further define "insurance company" nor authorize FHFA to adopt additional rules and regulations that could further restrict membership. In addition, since the adoption of the Bank Act, Congress has only expanded the eligibility requirements and mission of the FHLB system.[22] Further, having ample opportunity to limit captive insurance company membership since they first joined the FHLB system in 1994, Congress has never deemed it necessary to do so. In spite of frequently expressed and explicit congressional intent to expand the role of the FHLB system, the FHFA Proposed Rule would accomplish just the opposite through regulation. The FHFA's proposal to make membership eligibility requirements, including rigid quantitative tests, apply on an ongoing basis has no foundation in the Bank Act or its legislative history. Neither the legislative history of the Bank Act nor its subsequent amendments support the FHFA's construction of the membership eligibility requirements as ongoing tests, rather than point-in-time entry requirements.

[21] *See* Proposed Rule Comment Letter of John E. Bowman to Alfred M. Pollard, dated October 8, 2014, available at https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=12056, at 1-2 and 22-26 ("The [Proposed Rule] goes beyond interpreting and implementing the explicit language and intent of the Federal Home Loan Bank Act…in some areas, the FHFA's proposals directly contravene the intent of Congress and run contrary to subsequent acts of Congress that have served to broaden the scope of the FHLBanks' mission and membership," and "The FHFA's proposed rule, if finalized, would likely receive no deference from a reviewing court, since a court could easily find that the plain meaning of the term "insurance company," as used in the [Bank Act], and as intended by Congress, is clear on its face."); *See also* Proposed Rule Comment Letter of Thomas P. Vartanian to Alfred M. Pollard, dated October 31, 2014, available at https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=12299, at 9 ("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.")

[22] *See* HERA, 12 U.S.C. § 4513; FIRREA, 12 U.S.C. § 1424; and GLB, 12 U.S.C. § 1430.

Through the Proposed Rule, the FHFA seeks to effect amendments to the Bank Act's eligibility requirements without Congressional action and in contravention of clearly expressed Congressional intent. For the reasons discussed above, we respectfully request that FHFA withdraw the Proposed Rule.

Sincerely,

James S. Balloun
Chairman of the Board
Invesco Mortgage Capital Inc.

Richard J. King
CEO, Invesco Mortgage Capital Inc.

John M. Anzalone
Chief Investment Officer
Invesco Mortgage Capital Inc.

Robson J. Kuster
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