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Alfred M. Pollard, General Counsel
Attn: Comments/RIN 2590-AA39
Federal Housing Finance Agency
400 Seventh Street SW
Washington, DC 20024

Re: Comments/RIN 2590-AA39; Proposed Rules for Members of Federal Home Loan Banks

Mr. Pollard:

This letter is in response to the Federal Housing Finance Agency's Notice of Proposed Rulemaking, issued September 12, 2014. For your background, our firm provides regulatory services to the insurance industry in general as well as to the industry's regulators in Michigan.

The proposed restraints are *in general* extreme and will have the effect of materially limiting the ability of Federal Home Loan Banks to serve their Congressionally-established mission of providing liquidity in this still fragile economic environment. However, we comment *in particular* on the proposed rulemaking regarding membership of captive insurance companies and the FHFA's proposal regarding the definition of insurance company members' "principal place of business" as relates to member eligibility.

The FHFA's Proposed Bar on Captive Membership

Since 1932, Congress has recognized that insurance companies—which like banks and other depository institutions hold substantial assets for investment subject to state regulation—have an important influence on the housing finance market in the United States. Thus, the Federal Home Loan Bank Act provides that "*any* ... insurance company ... shall be eligible to become a member of a Federal Home Loan Bank," without reservation or limitation. Though captives—which like other insurance companies hold significant investable assets—have existed in a recognized regulatory sense in the United States since at least the 1970s, Congress has not undertaken any revision of the Act to narrow or otherwise limit its initial pronouncement that all insurance companies shall be eligible as members. Certainly, by 2008 when Congress last amended the Act, major US corporations across multiple industries had already formed captive insurers and were then benefitting from the risk-management advantages captives provide under state law.

The FHFA now proposes to interpret the unambiguous language of the Act in a manner inconsistent with Congress's plain intent by redefining "insurance company" to mean only "a

company whose primary business is the underwriting of insurance for *nonaffiliated* persons or entities." From the inception of the Federal Home Loan Bank System, Congress has refrained from defining "insurance company," leaving that task instead to the respective states as the primary regulators of their domiciliary insurance industries. The FHFA's proposed redefinition would not only go beyond its regulatory powers given the unambiguous language of the Act, but also would supplant state regulators who have striven over the last four decades to develop a rigorous regulatory scheme for the development and protective oversight of captive insurance companies.

Companies—even other insurance companies—form captive insurance subsidiaries for many reasons. Primary among these are that captives provide an opportunity for captive owners to directly benefit from internal risk-management programs and also to access efficient loss funding mechanisms for risks that the commercial insurance markets may be unwilling or unable to otherwise insure. Like other insurers, however, a captive is defined by its transfer of risk. Affiliated risks placed with a captive are not fundamentally different from third-party pooled risks placed in a "typical" insurer. The FHFA's proposed rule thus seeks to make a distinction without a difference.

Given the variety of insurance companies in the United States, the proposed redefinition would create significant uncertainty as to whether even those entities that are not classically termed "captives" would in continue to qualify for FHLB membership. Mutual insurance companies—among the oldest forms of insurance companies in the United States (e.g. the first was formed by Ben Franklin)—are by definition, operated for the benefit of their members, each of whom holds an ownership share in the company by virtue of their membership. The FHFA's proposed redefinition does not explain whether or how member-owned "mutual" insurers materially differ from member-owned "captive" insurers, especially "group captives" which insure by definition a number of member organizations at once. Nor does it explain how FHLBanks or their members are to determine whether the "primary business" of a captive insurer is to insure affiliated risks. This is especially troublesome given that captives may be authorized to insure third-party risks or may have other primary purposes (e.g. risk-management) wholly apart from affiliate risk retention.

The FHFA expresses concern in its NPR that captives may be formed by non-insurance companies (and in particular real estate investment trusts) for the purpose of allowing those companies to indirectly access FHLBank advances. This concern again states a distinction without a difference, as classic "stock" insurers can just as easily be owned by non-insurance parent companies. In Michigan, captives have <u>no</u> greater regulatory freedom to provide dividends to its parent companies than other forms of insurers. See MCL 500.4611(8); MCL 500.4729. Further, only a "pure captive" may make loans to its parent company or affiliates and then only upon the prior review and written approval of the Commissioner. See MCL 500.4639(3).

These restrictions on captive dividends and affiliate loans are part of a broader regulatory scheme under which captives are materially regulated in the same manner as other insurers. In Michigan, captive insurer formation is overseen by the Insurance Commissioner in a detailed application process and is subject to a thorough investigation prior to the captive being permitted to transact business. The applicant must develop a business plan satisfactory to state regulators, and like other insurers, must demonstrate evidence of the character, business probity, financial responsibility, and other qualifications of its officers and directors. See MCL 500.4603(6). Michigan captives are required to make their records available for examination without limitation (MCL 500.4603(6)(a)), and must submit annual reports to the Commissioner, including an opinion of a qualified actuary concerning the captive insurance company's reserves and compliance with the Code (See MCL 500.4621(2)). Like other insurers, captives must adhere to statutory paid-in capital and capital reserve requirements (MCL 500.4611), and the Insurance Commissioner has the authority to increase paid-in capital requirements as he or she deems necessary (MCL 500.4611(6)). MCL 500.4709(2).

Laws governing captives in other states may differ from those in Michigan, but this variation is but one more reason that the FHFA's proposed blanket prohibition on captives is unreasonable and potentially damaging to local insurance markets. The availability of FHLBank advances is of such central import to the Michigan insurance market that the Michigan Legislature has codified specific protections for the FHLBank system related to its lending to insurers, including captive insurers. That is, § 8115a of Michigan's Insurance Code explicitly prohibits a court from staying an FHLBank from exercising its rights under a security agreement with a Michigan captive, even where the insurer is insolvent or otherwise has been placed in receivership. See MCL 500.8115a(1)(b)(i); MCL 500.4655(1).

In sum, captive insurers are neither sufficiently different from typical insurers nor a "novel" form of insurance that requires the FHFA to act in lieu of Congress, especially where Congress has made a clear pronouncement that *all* insurance companies may be members in Federal Home Loan Banks. State regulators in Michigan, and elsewhere, have studiously advocated for and secured the adoption of robust regulations with respect to captives and other insurers. The FHFA's proposed exclusion would ignore these efforts and, especially when coupled with the FHFA's other proposed modifications to membership requirements, would have the effect of deflating opportunities for growth and greater efficiency in one of America's preeminent industries. The FHFA should, respectfully, thus withdraw its proposed rule and instead continue to work with the FHLBanks and state regulators to assure reasonable protections are in place to carry out the Congressionally-defined mission of the FHLBank system.

The FHFA's Proposed Redefinition of "Principal Place of Business"

The NPR states that the FHFA is proposing to clarify the standards by which a Bank is to identify an insurance company's "principal place of business" in determining the appropriate district membership. In particular, the FHFA intends to make plain that an insurance company's "principal place of business" is not synonymous with its state of domicile, but is instead located where, under a totality of the circumstances analysis, an insurer's officers direct the conduct of an insurer's business activities. Related to this proposal, the FHFA has, since April 3, 2012, maintained 2012-RI-02, in which the FHFA interpreted the term "principal place of business" in a similar manner. The NPR notes additionally that FHFA recently declined a request to allow the FHLBanks to look solely at the state of domicile to identify the principal place of business for insurance company members.

The request by the FHLBanks should have been granted and the NPR should be withdrawn or revised such that an insurer's member's domicile state is deemed to be its principal place of business (at least as the initial default). Use of the domiciling jurisdiction in initially establishing membership eligibility is desirable for a number of determinative reasons, the most important being that the laws of the state of domicile will govern (1) member insolvency, (2) the ability of a member to offer collateral, (3) and the rights of the FHLBanks as secured lenders to insurance companies. Because each state's laws are different as regards insurance regulation and reporting requirements, an interpretation of "principal place of business" that narrows—rather than broadens—the focus of FHLBanks to those few states within a FHLBank's jurisdictions is essential.

To assure the FHLBanks are adequately protected in their lending to all insurance members, the FHLBanks must of course establish strong relationships with local regulators (who will serve as the receivers in the event of member insolvency) and local counsel expert in state insurance laws. Under the new criteria in the NPR, any of the twelve FHLBanks may have members domiciled in any of the 50 states. In this way the NPR diffuses, rather than focuses, FHLBank resources relative to developing necessary control and monitoring.

In creating twelve, geographically distinct FHLBanks—as opposed to a single over-arching Bank—Congress undoubtedly intended that there be some level of local control and expertise exercised by each FHLBank as to its member institutions. The NPR's new scheme subverts this intent, and moreover, creates a credentialing framework that will require each FHLBank to engage in a time-consuming review of multiple factors that will slow the application process (potentially also reducing interest in membership as well). The NPR unnecessarily injects uncertainty into what would otherwise be a straightforward determination under state law.

. The NPR states that FHFA considered the recent United States Supreme Court opinion in *Hertz Corp v Friend* in developing its new approach; that case construed the federal diversity

jurisdiction statute, which is wholly unrelated to the Bank Act and which has markedly different purposes. The "principal place of business" standard in the federal diversity jurisdiction statute is concerned with judicial fairness and assuring that defendants are not subject to local impartialities (i.e., assuring that out-of-state defendants can remove suits to federal courts). It has nothing to do with Bank membership and its application to FHLBank membership of insurance companies will do nothing to foster robust regulations or strengthen the state-level relationships necessary for the FHLBanks to carry out their statutory mission.

In sum, the NPR (as well as 2012-RI-02) should be withdrawn, and the FHFA should instead adopt an interpretation which internalizes the fact that an insurer's home state always serves as its primary regulator. To do otherwise would harm, rather than help, the FHLBanks' ability to ensure they are protected under state laws in providing much needed liquidity to all its insurance members.

Sincerely,

Joseph A. Fink

Ryan M. Shannon

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