A wholly-owned subsidiary of CYS Investments, Inc.

December 29, 2014

VIA EMAIL: ***RegComments@fhfa.gov***
AND OVERNIGHT COURIER

Mr. Melvin Watt
Director
Federal Housing Finance Authority
400 Seventh Street S.W., Eighth Floor
Washington, D.C. 20024

Mr. Alfred Pollard
General Counsel
Federal Housing Finance Authority
400 Seventh Street S.W., Eighth Floor
Washington, D.C. 20024

RE: RIN 2590-AA39, NOTICE OF PROPOSED RULEMAKING AND REQUEST FOR COMMENTS INVOLVING PROPOSED CHANGES TO THE REGULATIONS CONCERNING FEDERAL HOME LOAN BANK MEMBERSHIP CRITERIA

Dear Messrs. Watt and Pollard:

CYS Insurance Services, LLC ("**CYSI**") welcomes the opportunity to comment on RIN 2590-AA39 (the "**Proposed Rule**"). CYSI is duly organized as a Tennessee limited liability company, licensed by the Tennessee Department of Commerce and Insurance as a pure captive insurance company pursuant to the provisions of Tenn. Code Ann. § 56-13-101 et seq. CYSI has been engaged in membership discussions with the Federal Home Loan Bank of Cincinnati (the "**FHLBC**") since March of 2014, and is a wholly-owned subsidiary of CYS Investments, Inc., a Maryland corporation ("**CYS**"). CYS is a New York Stock Exchange listed mREIT. Since its formation in 2006, CYS has been in the business of investing in and financing residential mortgages. CYS's assets consist solely of FNMA, FHLMC and GNMA mortgage securities ("**Agency RMBS**"), and CYS had total assets as of September 30, 2014 of approximately $14.5 billion. CYS, and CYSI's anticipated activities include a continued substantial commitment to the U.S. residential mortgage market through investments in Agency RMBS.

From discussions we've had directly with representatives of the Federal Housing Finance Agency (the "**FHFA**") on November 12, 2014 at their offices in Washington D.C., we understand that the primary concern underlying the Proposed Rule as it pertains to captive insurance company membership is one of "mission creep" and maintaining control of the type of parent companies that seek membership with a Federal Home Loan Bank ("**FHLB**") to those intended to benefit from such membership under the Federal Home Loan Bank Act of 1932 (the "**FHLB Act**"). The FHFA representatives expressed to us their concern that organizations, specifically mortgage real estate investment trusts ("**mREITs**"), not eligible for membership under the FHLB Act are using captive insurance companies as vehicles to access the FHLB system and advances. The representatives of the FHFA acknowledged that mREITs, as parents of captives, fit "squarely within the mission" of the FHLB system, and that mREITs do not create a "safety and soundness" issue. Simply, the FHFA expressed as a matter of policy that mREITs were not intended to be eligible members under the FHLB Act, and the FHFA is interpreting the definition of "insurance company" narrowly as it seeks to deny all captives from membership in the FHLB system.

While we appreciate that the FHFA has asked us how we suggest the FHFA might best tackle their policy concern, we find that it is difficult to address this concern constructively because the Proposed Rule states that, "[a]lthough mortgage REITs are involved in the residential housing finance markets, they are not among the types of institutions that Congress has authorized to become Bank members or to borrow from the Banks, and through the use of captives they have been able to borrow indirectly from the Banks - something the statute precludes them from doing directly. The Proposed Rule is intended to prevent these arrangements, which the FHFA views as circumventing the intent of Congress that the benefits of membership are to be available only to the types of eligible institutions enumerated in the Bank Act." In a related footnote, the Proposed Rule further states, "[t]his also raises safety and soundness concerns because, in the case of REITs, the Banks do not currently have access to the kind of detailed financial and supervisory information that is readily available to them in the case of institutions that are

eligible for Bank membership." Essentially, the statements included in the Proposed Rule conflict with, and are contrary to, what the FHFA representatives told us verbally.

For the reasons stated in this letter, we do not believe that captive insurance companies, or any other type of eligible member entity, facilitate "mission creep" because of the mission specific collateral requirements that apply to FHLB borrowing. Furthermore, we believe the "mission creep" concern of captive insurance companies is inaccurate and misplaced. There are many examples of banks and insurance companies owned by "non-eligible" members currently having access to the FHLB system. As a result, captive insurance companies should not be viewed any differently than any other eligible FHLB member. This is especially true because there is nothing to preclude the owner of a captive insurance company (like an mREIT) from owning a traditional insurance company or depository institution. Just like any other eligible member type, the membership eligibility of captive insurance companies should be judged based on their satisfaction of the relevant membership criteria, not their ownership or the structure of their insurance program.

Further, as the FHFA representatives acknowledged, CYSI and other like companies present no additional systemic risk, we play a strong and much needed role in housing finance, and we can grow as a healthy alternative to the diminishing liquidity in housing finance being evidenced by the pullback of the US Treasury and the GSEs. We also believe that the FHFA should address its membership concerns, not through the Proposed Rule, but in partnership with Congress, whose purview it is to amend the FHLB Act of 1932, as needed.

Upon review and inspection, we respectfully submit that the FHFA's concerns expressed in the Proposed Rule are theoretical and unsubstantiated; whereas the harms caused by the implementation of the Proposed Rule would be tangible, immediate, and significant.

EXECUTIVE SUMMARY

Supervisory Concerns

- The FHLB Act expressly states that *any* insurance company is eligible to become an FHLB member so long as certain specified conditions are met. The FHFA's proposal to define the term "insurance company" and the manner in which the term is defined (i) conflicts with the plain and unambiguous language of the FHLB Act, and (ii) constitutes a usurpation by the FHFA of legislative powers that are exclusively reserved to Congress.

- The FHFA's proposal to narrow the scope of eligible FHLB members is inconsistent with Congress' demonstrated and ongoing application and interpretation of the membership provisions in the FHLB Act. Congress has repeatedly adopted an inclusive and expansive approach, extending membership to commercial banks and credit unions in 1989 and, more recently, to community development financial institutions ("**CDFIs**") in 2008.

- The FHFA expresses concern that captive insurance companies did not exist and were not contemplated by Congress in the enactment of the FHLB Act; *however*, insurance companies formed to exclusively insure the risks of the parent organization were in fact in existence when the FHLB Act was passed. Further, this position undermines the principles of the U.S. legislative process, and is inconsistent with Congress's review of the FHLB Act over time. Congress has had several opportunities to clarify the definition of "any insurance company", and has not ever decided to limit the scope of the broad definition.

- Recent government-sponsored entity ("**GSE**") reform efforts have emphasized the need to reduce government involvement and taxpayer risk by bringing private, at-risk capital into the mortgage market. The FHLBs, with their cooperative membership structure and sophisticated credit policies/procedures that involve over-collateralized borrowing and asset/activity-based stock purchase requirements, provides a safe mechanism for accomplishing the capital infusion goals of GSE reform.

- The FHLBs' ability to fulfill its statutory mandate to provide liquidity to members was clearly demonstrated during the recent financial crisis, during which the FHLBs were an important source of stable and ample liquidity to their members. The Proposed Rule, which seeks to restrict FHLB membership, frustrates this goal, and could serve to further the continuation of the current problems the U.S. mortgage market has been experiencing and limit access to mortgages.

- The FHFA asserts that the definition of "insurance company" in the Proposed Rule will exclude captive insurance companies. We disagree. Captive-enabling state legislation generally permits captives to write certain types of non-affiliated business. As a result, captive insurance companies can satisfy the FHFA's proposed definition of "insurance company".

- The current and prospective captive insurance company members of the FHLBs have a substantial commitment to the U.S. mortgage market, and their businesses and activities are consistent with, and support the mission of, the FHLBs. In many cases, the entire investment portfolio of captive insurance company members is comprised of assets that would qualify as FHLB mission-specific and eligible collateral for borrowings. In the Proposed Rule, the FHFA characterizes captive insurance companies as "conduits" that are being used to facilitate access to FHLB borrowing for organizations that otherwise would not qualify as members; *however*, the FHFA fails to express the problem with such an arrangement. Many of the current members of FHLBs serve as "conduits" to FHLB advances, but the ultimate result of the "conduit" is the substantial advancement of the mission of the FHLBs. Captive insurance companies do not serve as any more of a "conduit" for FHLB-advanced funds than other entity type that is an FHLB member insofar as (i) as funds from FHLB advances are fungible, (ii) the captive insurance company members are abiding by the same policies and procedures as other members, and (iii) the captive insurance companies are utilizing the same financing structures and mechanisms to acquire and pledge eligible collateral to the FHLBs that are available to all other member types.

- FHLBs require members to pledge eligible collateral, which are generally limited to residential and multi-family commercial whole loans, agency and non-agency residential mortgage-backed securities and commercial mortgage-backed securities, in order to obtain advances. Access to FHLB-advance funds being limited to the amount and availability of a member's eligible collateral serves as a self-regulating safeguard against the occurrence of what the FHFA refers to as "mission creep" (i.e., the use of FHLB funds to finance activities that are not consistent with the mission of the FHLBs).

- The FHLB system benefits from a diverse and robust membership, which supports the housing finance system, affordable housing, and community development. In 1989, Congress amended the FHLB Act to ***broaden*** the scope of the FHLBs incidental powers. The legislative history of the amendment highlights that the amendment ensured that "the banks may provide a variety of products and services. This variety makes membership in the banks appealing to eligible institutions. By sustaining members, the banks are better able to meet the financial obligations that the act imposes."[1]

Safety and Soundness Concerns

- The FHLBs have been in existence for over 80 years. During that time, they have successfully navigated numerous credit cycles. In an August 1, 2013 report, Moody's notes that the FHLBs have "never incurred a loss on an advance in its 80-year history. The FHLBanks' collateral requirements on advances, and their preferred creditor status, support asset quality in the event a member defaults on its advances." This history strongly suggests that the FHLBs have sufficient processes and procedures in place to manage credit risk. The processes and procedures include imposing membership and activity stock purchase requirements, imposing overall borrowing capacity limitations, specifically underwriting members' credit and valuing collateral on a case-by-case basis, requiring physical possession of certain types of collateral, and imposing

[1] 135 Cong. Rec. H4994 *daily ed. August 3, 1989 (remarks of Congressman Garcia).

various "haircuts" that adjust based on the type and nature of the collateral. Because the arrangement deals with the exact same policies and procedures and the exact same type of collateral, captive insurance companies do not pose any different or additional credit risk to the FHLB system than any other type of member entity.

- FHLBS have had captive insurance companies as members since 1994, indicating a long and successful history of operating within the FHLB system. Captive insurance companies are subject to the same scrutiny as any other member to ensure that they share the housing policies and goals of the FHLBs. The FHFA has not cited any evidence showing that captive insurance companies pose a specific, identifiable risk or harm to the FHLBs, or the FHLB system.

- Contrary to the FHFA's suggestion, captive insurance companies generally have a much lower rate of insolvency than traditional insurers. The insurance programs of the FHLB captive insurance company members are straightforward, and typically losses are fully funded in capital. As a result, unlike other FHLB member types, the credit risk associated with captive insurance company members is typically only associated with the investment risk of FHLB mission-specific assets.

- Captive insurance companies are licensed and regulated by states. Captive insurance companies, among other things, typically are required to file annual audited financial statements with state insurance regulators. Furthermore, captives are prohibited from transferring assets without regulatory approval, which requires confirmation of ongoing solvency following the transfer. As a result, FHLB advances to a captive, even if transferred to a parent of the captive, are made to a licensed, regulated, and safe counterparty.

Additional Considerations

- Current figures from the FHLBs indicate that there are approximately $10 billion in FHLB advances outstanding to captive insurance company members. Simply eliminating, or "phasing out," the membership and borrowings of current captive members would reduce the income of FHLBs with active captive members and thereby reduce the funds available to support affordable housing programs ("**AHPs**"). Furthermore, the loss of income would adversely impact certain FHLBs and their members in a material way. In some cases, the financial impact would be so significant that it could jeopardize the independent status of one or more of the FHLBs and force consolidation.

- Interest rate volatility and unavailability of ongoing funding were two of the primary causes of U.S. mortgage market crises. The FHLBs provide members with long term funding options that allow members to better match financing terms with the terms of the underlying asset, thereby mitigating interest rate risk. The FHLBs also serve as a stable and reliable source of funding during times when other funding may be difficult to obtain or non-existent. The long term and reliable nature of FHLB funding assists in combatting mortgage market crisis risks, and promoting access to such tools decreases the overall risk to the market.

- The equal protection provisions inherent in the Due Process Clause of the Fifth Amendment of the U.S. Constitution and Rule 7(j) of the FHLB Act prohibit treating similarly situated organizations differently for purposes of FHLB membership eligibility. The Proposed Rule violates both the Due Process Clause and Rule 7(j) because it treats (i) captive insurance companies differently than traditional insurance companies, even though there may not be practical distinctions between the organization types, and (ii) current FHLB captive insurance company members differently from prospective captive insurance company members for purposes of the five year "sunset" period based on something as arbitrary as the organization's FHLB status as of the date of publication of the Proposed Rule.

- We believe that the ongoing membership asset test proposed by the FHFA will have a stifling effect on the FHLB system. Through proposed ongoing requirements, the FHFA would be effectively mandating a permanent minimum asset allocation to FHLB members, which could lead to significant disruptions to the day-to-day workings of the FHLBs because members may be required to terminate their memberships and redeem their capital stock only to later re-qualify and possibly rejoin the FHLB.

- The FHFA does not provide evidence to support the "concerns" noted in the Proposed Rule, and does not offer analysis regarding the financial impact of the Proposed Rule to the FHLBs, their members or the mortgage market as a whole. This type of information and analysis is of the utmost importance to effective rulemaking and to ensuring informed discussion that is a fundamental component of notice-and-comment rulemaking. Many of the FHFA's assertions regarding captive insurance companies in the Proposed Rule are erroneous, and implementation of the Proposed Rule would have material adverse consequences to a vast number of parties, including the general public as participants in the U.S. mortgage market. It is imperative that the FHFA carefully consider, analyze and describe the costs and benefits of the Proposed Rule. CYSI strongly believes that such analysis will confirm the need to withdraw the Proposed Rule.

DISCUSSION

I. Supervisory Concerns

With respect to the supervisory concerns, the FHFA suggests that captive insurance company members are problematic because their membership is not consistent with congressional intent under the FHLB Act, and that they are being used as a "conduit" to access FHLB borrowing for otherwise ineligible entities.

a. The Membership Eligibility Provisions in the FHLB Act are Broadly Worded and Construed, and have been Expanded by Congress

While the FHFA generally is responsible for the regulatory oversight of the FHLBs and ensuring that their operations and activities are consistent with the provisions of the FHLB Act, the FHFA is not permitted to amend or modify the provisions of the FHLB Act. The FHFA attempts to circumvent this limitation by asserting that it is merely exercising its regulatory authority by defining the term "insurance company" for purposes of clarifying the scope of eligible FHLB members. However, this assertion contradicts traditional notions of statutory interpretation. Regardless of the context, it is a generally accepted principle that, absent ambiguity, statutes should be applied in accordance with their plain language. The concept underlying this principle is that legislatures act deliberately in adopting legislation and, therefore, the intent and desired application of the statute is most apparent from the plain language of the statute.

With respect to the FHLB Act, the membership eligibility provisions are broad and apply to "[a]ny . . . insurance company," as long as such company (i) is duly organized under the laws of any state, (ii) is subject to inspection and regulation, and (iii) makes long term home mortgage loans (which includes holding interests in assets securitized by such loans). Congress has the authority to define "insurance company" and other eligible entities under the FHLB Act. In 1932 when the FHLB Act was passed and when insurance companies were originally included as eligible members, life insurers were the primary insurance companies engaged in the business of providing or investing in residential mortgage loans. The fact that Congress elected not to define the term "insurance company" or specifically limit eligibility to life insurance companies as eligible members, and instead included the term "any insurance company" as an eligible FHLB member unequivocally establishes Congress' intent for FHLB membership eligibility to be construed as broadly as possible to support to purpose of the FHLB Act and the mission of the FHLBs. Defining the term "insurance company" in the manner suggested in the Proposed Rule to exclude certain entities that are organized, licensed and regulated as insurance companies is not, as the Proposed Rule suggests, within the scope of the FHFA's rulemaking authority. Instead, it conflicts with the clear and unambiguous text of the FHLB Act, which can only be amended through congressional action.

If the FHFA legitimately believes that the phrase "any insurance company" in the FHLB Act is ambiguous and really means "certain insurance companies" that satisfy the FHFA's proposed definition, then the issue of amending the language should be raised for Congress to address. On multiple occasions, Congress has expanded the categories of eligible members and facilitated access to the important funding the FHLBs provide. Specifically, Congress expanded membership to commercial banks and credit unions in 1989 and, more recently, to CDFIs in 2008. It is illogical to think that Congress would suddenly reverse its approach to expanding access to the FHLBs by narrowly construing the term "any insurance company" to exclude certain types of insurance companies.

b. Congressional Intent

In the Proposed Rule, the FHFA states that captive insurance companies did not exist when the FHLB Act was passed and, therefore, Congress could not possibly have intended to include the entities in the category of eligible "insurance companies." This position is incorrect. Even though the term "captive insurance company" and the corresponding captive insurance-enabling state laws may not have existed when the FHLB Act was passed, insurance companies formed to exclusively insure the risks of the parent entity(ies) were in existence when the FHLB Act was passed. For example, the Episcopal Church formed Church Insurance Company in 1929 to cover risks associated with member churches (see the copy of the New York Times article below dated May 23, 1929). Given that the company's formation was on the front page of the New York Times and J. Pierpont Morgan was Chairman of the company's Board, it is highly likely that at the time the FHLB Act was passed, Congress was aware of the concept of limited purpose insurance companies of the precise type and nature that the FHFA proposes to exclude under the Proposed Rule.[2]

In addition, the FHFA's position undermines the principles of U.S. legislative process by suggesting that it is necessary to demonstrate that Congress contemplated a specific context or concept before a law may be properly applied. Such an interpretation, if correct, would result in legislatures being in a perpetual state of updating laws in order to address their application to the continuing innovations and developments that occur on a daily basis in the U.S. As noted above, the plain language of the FHLB Act clearly indicates that the law was written to achieve the particular result of enhancing liquidity in the U.S. mortgage market. Accordingly, with such a result-driven purpose, it is incongruous for the FHFA to postulate that the phrase "any insurance company" should be read to include only such subset of insurance companies that existed when the FHLB Act was passed, when in fact, the activities of the insurance companies in question are as consistent, if not more, with the purpose of the FHLB Act than almost any other FHLB member.

c. The Proposed Rule is Inconsistent with Recent GSE Reform Efforts

The stated purpose of the Proposed Rule to exclude captive insurance companies as eligible FHLB members is inconsistent with current legislative and regulatory efforts concerning the U.S. mortgage market and efforts to promote and fund affordable housing in the U.S. In particular, one of the main goals of recent GSE reform efforts has been to bring private, at-risk capital into the mortgage market. With Fannie Mae and Freddie Mac still in conservatorship, the federal government guaranteeing or insuring over 90% of new mortgages, and the Federal Reserve's enormous QE balance sheet, it is clear that there is a need for an infusion of private capital into the U.S. mortgage market. While seven years have elapsed since the mortgage crisis began, government intervention and U.S. taxpayer exposure to the mortgage market remain high. Allowing captive insurance companies that support the mission of the FHLBs by financing or investing in residential mortgage assets to become members of the FHLBs is an effective tool to encourage an infusion of private capital.

The FHLBs have always served as an alternative option for enhancing liquidity in the US residential mortgage market and, as described below, have done so with far more financial stability and better credit risk controls than Fannie Mae, Freddie Mac and Ginnie Mae. However, the ability of the FHLBs to play a greater role in

[2] *See* Shanique Hall, *Recent Developments in the Captive Insurance Industry*, CIPR Newsletter (Jan. 2012), *available at* http://www.naic.org/cipr_newsletter_archive/vol2_captive.htm (discussing "captive" programs organized as early as the 1920's).

mitigating the taxpayer, investor, and government exposures associated with other GSEs is limited by the number, borrowing capacity and eligible collateral of the FHLBs' members. Accordingly, the significant influx of private capital and high concentration of mission-specific collateral associated with captive insurance company members of the FHLBs should be viewed favorably and welcomed by the FHFA as a way to transition away from the over-dependent relationship with Fannie Mae, Freddie Mac and Ginnie Mae.

d. The Regulation of Insurance Companies is the Responsibility of States

Underlying the delegation of insurance regulation to states in the McCarran–Ferguson Act is the emphasis on the need for there to be clear and consistent oversight of insurance by experienced regulators who understand the applicable laws of the states and the activities of the insurance companies. In the Proposed Rule, the FHFA states that the definition of an "insurance company" to mean "a company whose primary business is the underwriting of insurance for nonaffiliated persons" would have the "principal effect" of prohibiting captive insurers from becoming FHLB members. There are various types of captive insurance companies, but even the most straightforward type of captives, commonly known as "pure captive insurance companies", are permitted in most states to underwrite certain types of unaffiliated business. This underwriting of unaffiliated business easily could constitute a majority of a captive insurance company's business. A significant portion of captive insurance companies qualify as "insurance companies" for U.S. federal income tax purposes, which among other things, means they have sufficient distribution of risk. In that regard, the treatment of these captive insurance companies under the Internal Revenue Code (and by the IRS) is indistinguishable from the treatment of "traditional" insurance companies. Accordingly, contrary to the FHFA's assertions in the Proposed Rule, many captive insurance companies satisfy the "insurance company" definition therein. Neither the FHFA nor the FHLBs are in a position or have the expertise to scrutinize the specific operations or activities of eligible FHLB members (insurance company or otherwise), and because no such scrutiny is required under the broad, all-inclusive language of the FHLB Act, the provisions in the Proposed Rule concerning the scope of coverage provided by insurance companies are unnecessary and raise significant concerns about potential unjust and arbitrary application of the membership standards and federal interference with state regulatory matters.

e. The Proposed Rule Mischaracterizes Mission-Specific Financings as Problematic "Conduits"

One of the concerns raised by the FHFA most frequently in the Proposed Rule pertains to their characterization of captive insurance companies as "conduits" for financing activities of non-eligible entities. In expressing this concern, the FHFA fails to illustrate the difference and the problems inherent of a captive insurance company serving as a "conduit", as compared to any other member acting as a "conduit". To be clear, there is no restriction in the FHLB Act on such transfers from a member to an affiliated entity. In addition, the FHFA does not provide any information in the Proposed Rule evidencing the extent to which the FHFA is aware of, or investigated as part of the necessary due diligence in connection with the Proposed Rule, other types of eligible FHLB entities that transfer FHLB advanced funds to ineligible entities within the same corporate system. Based on the FHLBs history of not having ever suffered a loss on advances, it is unlikely that the FHFA has ever had any cause to look into this issue. However, because it is being highlighted as a problematic aspect of captive insurance arrangements, one would assume that the perceived problems, if legitimate, would have caused the FHFA to evaluate the prevalence of the practice rather than merely isolating a particular class/category of FHLB members. The "supervisory concerns" expressed in the Proposed Rule regarding "conduits" are entirely conceptual in nature, and it is impossible to grasp the concept of eliminating membership for entities whose activities and assets are as consistent with the mission of the FHLBs as any other eligible member.

f. Current FHLB Membership Criteria and Borrowing Policies and Procedures Protect Against "Mission Creep"

Akin to the "conduit" argument discussed above, the FHFA cites to the use of captive insurance companies as a cause of what they refer to as "mission creep," meaning the access to and use of FHLB-advance funds to finance activities that are not necessarily consistent with the U.S. mortgage market-specific purpose of the FHLBs. This characterization of the activities and assets of captive insurance company members of the FHLB is wholly

unsubstantiated by any support, and is a severe, unjust, and unfair over-generalization that in no way serves as a justifiable basis for eliminating membership of an entire class of eligible entities.

The "mission creep" characterization is misplaced in the context of captive insurance company members of the FHLBs. CYSI believes that, on average and by comparison to other FHLB member types, captive insurance companies' activities and assets are more directly aligned with the mission of the FHLBs. Further, the collateral eligibility requirements and the over-collateralized nature of the FHLB advances provide a protective mechanism that is inherent in the FHLB system against "mission creep." Specifically, members can only borrow from the FHLBs to the extent they have eligible assets available to be pledged. The result is that the ongoing borrowing capacity and access to funds of any member directly correlates with the replenishment of eligible assets by any such member. If there was truly an issue relating to "mission creep" whereby FHLB funds are used for non-mission specific purposes, then any potential harm would be mitigated by the self-defeating nature of the system through which the FHLBs provide advances to members. That is, if FHLB funds are increasingly used for non-mission-specific activities, then eventually the member organization will run out of eligible collateral to pledge. There is only so much "mission creep" that can occur before the protections embedded in the process of making FHLB advances will arrest "mission creep." This self-regulating mechanism is important because it provides a systemic and embedded process to police the mission-specific scope of activities without requiring the FHFA or the FHLBs to trace the use of particular funds or monitor the scope of activities of all members, both of which would be virtually impossible in light of the fungible nature of funds and the significant number of FHLB members.

II. Safety and Soundness Concerns

Turning to the "safety and soundness" concerns, the FHFA argues that captive insurance company members present unique and material credit risks to the FHLBs.

a. The FHLBs Have Processes and Procedures in Place to Mitigate Credit Risk

In over 80 years of existence, the FHLBs have never sustained a loss on its advances to members. This experience evinces that the FHLBs have established safe and sound processes, procedures and controls to protect against the credit risk of member borrowing, regardless as to whether the member is an insurance company, bank, credit union, or otherwise. On this point, it is CYSI's understanding that although there generally are three categories related to the method of pledging collateral to the FHLBs (i.e., blanket lien status, listing status, and delivery status), the delivery status method is most commonly utilized or required for collateral pledged by insurance companies. This method, which specifically gives the FHLB physical possession of the pledged assets, provides the FHLBs with significant protection against credit risk.

Captive insurance companies are generally pledging the exact same types of assets and collateral as the other FHLB members. Furthermore, like all other members, captive insurance companies are required to purchase (i) membership stock based on the applicable asset test of the FHLB, and (ii) activity stock based on the amount of active borrowings. Therefore, if FHLB advances are provided on an over-collateralized basis and the FHLB credit/collateral policies and procedures and stock purchase requirements are consistently applied, then it is unclear how or why captive insurance company members would present any greater or lesser credit risk to the FHLBs than any other member. Interestingly, CDFI members lack a federal or state-sponsored backstop or insurance fund (*e.g.*, the FDIC, NCUA, etc.) in the event of insolvency, which theoretically may be viewed as an enhanced credit risk as compared to other FHLB members, and yet CDFIs were explicitly approved by Congress as eligible FHLB members in 2008, and their continuing membership/unique credit risk is not being questioned in the Proposed Rule.

b. Captive Insurance Companies Do Not Present Unique Credit Risks

The FHFA does not provide any evidence to support its claim that captive insurance companies pose greater credit/default risk than other members, including traditional insurance companies. Industry data

demonstrates that captive insurance companies fail at a much lower rate, proportionally, than traditional insurers.[3] The explanation for the lower rate of failure is actually one of the reasons cited by the FHFA as a potential concern – alignment of interests. Many captive insurance companies insure the risks attributable to their owners, and, as a result, the owner-insureds have a vested interest in ensuring the ongoing solvency and financial strength of the entity. If a captive insurance company becomes insolvent, then the owners potentially lose both their insurance coverage (*i.e.*, they become uninsured or self-insured and directly responsible for paying loses) and their investment in the subsidiary.

Not only do captive insurance companies generally have a lower default rate than traditional insurers, but also the default of single parent captive insurance companies is extraordinarily rare. Most FHLB captive insurance companies (including CYSI) are formed as single parent, pure captives and, in most cases, the insurance risk is *fully funded* in capital, as required by state regulation. As a result, the likelihood that an FHLB captive insurance company member would experience a default in connection with its insurance program is highly unlikely. Therefore, unlike any other eligible FHLB member, the credit risk of captive insurance company members is almost exclusively tied to the underwriting of FHLB mission-specific investments.

c. Captive Insurance Companies are Subject to Similar Regulatory Supervision as Traditional Insurers

Captive insurance companies are subject to similar regulatory framework as traditional insurance companies (and, as a general matter, are subject to far more oversight and regulation than CDFIs). As part of the state regulatory framework, captive insurers (i) must submit financial information (including, in most jurisdictions, audited financial statements and certifications from an independent actuary regarding the sufficiency of funding) to the state regulator at least annually, (ii) must maintain minimum capital and surplus to satisfy state law (net of the actuarially determined loss reserves), (iii) are prohibited from distributing assets from the captive without regulatory approval, (iv) must submit a business plan to the regulator, conduct business solely in accordance with such plan, and submit any proposed changes to the regulator for approval, (v) must engage an independent auditor and independent insurance manager, and (vi) generally have at least one independent manager/director serving on the board. If the ongoing solvency of a captive becomes a concern, state regulators typically intervene to varying degrees depending on the level of concern. Such intervention can include actions such as requiring that the parent company contribute more capital, requiring the captive to charge higher premiums, requiring more frequent financial reports, or, in worst case scenarios, suspending the captive's license. As a result of the foregoing, contrary to the FHFA's suggestion, it is very unlikely that the captive insurance company could ever operate against its own self-interest or that its financial condition could deteriorate rapidly without the regulator's and/or the FHLB's knowledge. Such rapid deterioration in the context of FHLB captive insurance company members would be almost exclusively limited to a significant and severe decrease in investment value. However, such investment risk is not unique to captive insurance companies and is shared by all FHLB members.

III. The Proposed Rule is Harmful to the FHLBs and the U.S. Mortgage Market

The proper way to evaluate the need for regulatory action is to first identify a problem intended to be addressed by the action; next, to evaluate the likelihood that the action will correct the problem; and lastly, to determine whether the benefits outweigh costs or collateral damage associated with the action. The Proposed Rule does not address any specific, tangible problem, raises theoretical and conceptual issues, and would actually serve to harm the FHLBs and the U.S. residential finance market. The issues noted by the FHFA do not serve as a basis for justifying the validity of the Proposed Rule. Further, the Proposed Rule is devoid of any information and analysis concerning the impact the rule would have on the FHLBs (both from a financial and membership status perspective), the U.S. mortgage market or the AHPs. This is of particular concern because this information and analysis is of

[3] See A.M. Best, Special Report on U.S. Captive Insurance (August 2014) (comparing various financial and solvency ratios of captive insurance companies with traditional insurers and finding that captives "substantially outperformed" their traditional insurer counterparts).

paramount significance to facilitating the type of robust and informed discussion that is the fundamental principle of notice-and-comment rulemaking. Accordingly, the Proposed Rule fails the criteria of sound regulation.

There are 20 current captive insurance company members of the FHLB. Even though the number is limited, captive insurance companies represent a significant portion of the active borrowings of the FHLBs, with figures indicating that there are approximately $10 billion in FHLB advances outstanding to captive insurance company members. In the FHLB of Indianapolis alone, the advances to captive insurance companies constitute approximately 10% - 20% of the total outstanding advances. If the membership of the current captive insurance company members of the FHLB is terminated, then it will have a significant and immediate corresponding effect on (i) the liquidity available in the U.S. mortgage market, (ii) the financial performance of the FHLBs, and (iii) the amount of funding available for the continued advancement of affordable housing. In some cases, the financial impact could be so severe that it could jeopardize the independent status of one or more of the FHLBs and could force consolidation. When the impact is expanded from the current membership to the prospective opportunities that would be eliminated by precluding new captive insurance companies from becoming members of the FHLBs, the adverse consequences would be compounded annually.

An equally troubling consequence of the Proposed Rule is the effect it will have on the funds available to support AHPs. FHLBs do not pay federal income tax and, instead, are obligated to contribute 10% of their annual income to AHPs through various grant programs. The termination of current captive insurance company members and the prohibition of future captive insurance company members will significantly reduce the amount of total outstanding actual advances and eliminate future advance opportunities, which in turn will reduce the annual income of the FHLBs. If the FHLBs' annual income is reduced by the Proposed Rule, then the funds available for AHP grants will, likewise, be reduced. This result is a significant adverse consequence of implementing the Proposed Rule in its current form. However, because it is not highlighted or discussed in the Proposed Rule, people and organizations that benefit from or depend on AHP grants may be completely unaware of the impact the Proposed Rule will have on them. The FHFA must be more transparent in stating the consequences of the Proposed Rule and defending the validity of the Proposed Rule in light of those consequences.

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 FHLB Act. Although we do not expect the proposed ongoing eligibility requirements would affect the manner in which CYSI 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."

Restricting FHLB membership through the FHFA's newly-proposed eligibility requirements, including the elimination of a class of members permitted by the FHLB 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.

IV. Captive Insurance Company FHLB Members Lower Mortgage Market Risk and Volatility

Interest rate risk is one of the most critical and potentially harmful risks related to the reemergence, continuation, and health of the U.S. mortgage market crisis. Most borrowers generally have been limited to utilizing shorter term repo borrowing arrangements as their primary means to finance investments in U.S. mortgage market assets or otherwise supporting the U.S. mortgage industry. In most instances, the repurchase arrangements are short term in nature (overnight to 30 days) even though the underlying assets may be for a much longer duration. This mismatch in the term of a financing and the term of the asset creates potential risk associated with the volatility of interest rates, which impacts the profitability of the underlying asset. Furthermore, in the event of a market crisis, short term funding can be difficult to obtain or entirely nonexistent. This unavailability of funding, in turn, can lead to an exacerbation of the crisis as borrowers are forced to sell off assets in order to generate sufficient liquidity to support ongoing operations.

The FHLBs provide a source of stable and long term funding. This enables members to better manage their interest rate risk by matching the term of funding with the term of the underlying asset. The reduction in risk associated with interest rate volatility facilitates more investment in mortgage market assets, thereby mitigating the likelihood of a crisis. Likewise, in the event a U.S. mortgage crisis does arise, the long term funding and stability/reliability of FHLB funding serve as valuable mechanisms for both (i) assisting members in navigating and surviving the crisis, and (ii) limiting the duration of the crisis.

As noted above, the current captive insurance company members of the FHLBs represent a notable portion of the outstanding advances and the advances would likely significantly grow over the next several years as additional members (captive insurance companies and otherwise) join and borrow. The combination of the substantial level of U.S. mortgage assets held by captive insurance companies with the benefits associated with the long term and reliable nature of FHLB funding materially reduces the overall risk of a mortgage market crisis from emerging or continuing. Accordingly, contrary to the FHFA's suggestion, precluding captive insurance companies from FHLB membership increases the overall risk in the U.S. mortgage market because it limits the number of eligible entities access to the tools available through FHLB funding that are critical in preventing and combating the causes of mortgage market crises.

V. The Proposed Rule Results in Unequal Treatment of Similarly Situated Entities

The equal protection provisions inherent in the Due Process Clause of the Fifth Amendment of the U.S. Constitution generally prohibit the federal government and its representatives (like a federal agency) from treating similarly situated members of a particular class unequally. In addition, Rule 7(j) of the FHLB Act mandates the

equal treatment of FHLB members and prohibits discriminating against a particular membership class. Access to the borrowings and other programs of the FHLBs is a significant benefit to members, and provides member organizations with a competitive advantage over non-member organizations. In the Proposed Rule, the FHFA (i) distinguishes captive insurance companies from all other types of eligible FHLB members (including traditional insurance companies) for purposes of excluding captives from membership, and (ii) distinguishes between captive insurance companies that have been admitted as FHLB members prior to the publication date of the Proposed Rule and all other captive insurance companies (including those unjustly delayed in the membership application process by the moratorium) for purposes of the five year membership and borrowing sunset period. Both of these actions violate the U.S. Constitution and Rule 7(j).

As discussed throughout this letter, in almost all facets and especially with respect to the matters most relevant to the intent of the FHLB Act, there is no material difference between captive insurance companies and traditional insurance companies. Captive insurance companies and traditional insurance companies are indistinguishable for purposes of the membership eligibility criteria enumerated in the FHLB Act, and there is no rational basis for the FHFA to categorically exclude captive insurance companies as eligible FHLB members.

In addition, it is unlawful for the FHFA to treat, or require the FHLBs through the Proposed Rule to treat, current captive insurance company members differently from prospective captive insurance company members. As part of the membership process, and specifically the issuance of the FHLB member number, the FHFA presumably reviewed and approved the membership of each of the current captive insurance company members of the FHLBs. During that process, which has occurred over the last 20 years following the date when the first captive insurance company joined an FHLB in 1994, the FHFA never raised any objections like those articulated in the Proposed Rule. In fact, it was not until December 27, 2010 when the FHFA released a 25 page Advance Notice of Proposed Rulemaking (the "**ANPR**") that any potential concerns with captive insurance company members were raised. However, the ANPR received negative feedback and no resulting final rule was implemented. After the ANPR, several additional captive insurance companies were admitted as members of the FHLBs and were issued member numbers by the FHFA.

Despite the fact that the FHFA has acquiesced to captive insurance company members of the FHLBs for 20 years, it nevertheless is attempting to require different treatment of similarly situated captive insurance companies based on something as arbitrary as FHLB membership status as of the date the Proposed Rule was published. There are numerous prospective FHLB member organizations like CYSI that are nearly identical to the captive insurance companies that are current members of the FHLBs. No rational distinction between organizations like CYSI and current captive insurance company FHLB members can be made for purposes of determining the entitlement to access the benefits of FHLB membership. Regardless as to whether such distinction applies for one day or for the entire five year sunset period noted in the Proposed Rule, the disadvantage and harm that would be suffered by the FHFA's exclusion of captive insurance companies would be significant and readily apparent by comparison to the captive insurance companies that were members as of the publication date of the Proposed Rule.

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Conclusion

For the reasons stated herein and in other comments submitted, CYSI respectfully requests that the FHFA refrain from implementing the provisions of the Proposed Rule concerning captive insurance company membership and eligibility, and withdraw the Proposed Rule. Captive insurance companies have been stable members in good standing of the FHLB system for over 20 years and through multiple credit cycles, and have historically played a significant role in supporting the mission of the FHLBs and can continue to play and expand that role in a safe and sound manner on an ongoing basis. In the alternative, CYSI urges the FHFA to conduct a thorough financial impact analysis on the Proposed Rule and share the results with the general public. While doing so, the FHFA should suspend further rulemaking on this proposal until such time that the FHFA can adequately identify and substantiate the problems that the Proposed Rule is intended to address.

Very truly yours,
CYS INSURANCE SERVICES, LLC

Kevin E. Grant, President

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c: Thomas A. Rosenbloom, Executive Vice President of Business Development, General Counsel, & Secretary