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January 9, 2015

Mr. Alfred M. Pollard  
General Counsel  
Federal Housing Finance Agency  
400 Seventh Street SW, Eighth Floor  
Washington, DC 20024

Attention: Comments/RIN 2590-AA39

Dear Mr. Pollard:

Redwood Trust, Inc. (“Redwood”), a mortgage real estate investment trust (“REIT”), and RWT Financial, LLC (“RWT Financial”), a wholly-owned captive insurance company subsidiary of Redwood, appreciate the opportunity to comment on the Notice of Proposed Rulemaking (“NPR”) published by the Federal Housing Finance Agency (“FHFA”) regarding proposed changes to Federal Home Loan Bank (“FHLBank”) membership regulations.<sup>1</sup> We understand that the proposed changes are intended to ensure that the benefits of FHLBank membership are used to further the FHLBank System’s mission while maintaining safety and soundness. However, we are concerned that the NPR unrealistically views all captive insurance companies and their parent companies as having one common form, function, and scope of business activities, and then uses that viewpoint as a rationale to categorically exclude all captive insurers from membership in the System. In doing so, the NPR fails to take into account that captive insurance companies can serve an important role in responsibly providing liquidity to the residential housing finance market and furthering the statutory mission of the FHLBank System.<sup>2</sup>

As detailed in this comment letter, categorically excluding captive insurance companies from FHLBank membership is not in the best interests of the FHLBank System or the homeowners it ultimately seeks to serve, and we respectfully request that the FHFA withdraw this portion of the proposed regulation. To the extent any particular captive insurance company that is a current or prospective member of the FHLBank System presents either mission- or safety and soundness-related concerns, we believe that the existing regulations, the existing membership application process, and the existing processes for ongoing review of members’ financial condition, activities, and collateral for advances provide the appropriate authority and means to address those concerns in each instance when they may arise on a company-by-company basis.

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<sup>1</sup> 79 Fed. Reg. 54848 (Sept. 12, 2014).

<sup>2</sup> Among other articulations of the FHLBank System’s mission, Congress set forth a formulation of the mission of the FHLBank System, in the Housing and Economic Reform Act of 2008, Pub. L. No. 110-289 (July 30, 2008). In several sections, Congress recited “the housing finance and community and economic development mission of the Federal Home Loan Banks” and “the mission of providing liquidity to members.” 12 U.S.C. §§ 4512(e)(2), (f)(1)(B).

Specifically with respect to RWT Financial, we believe that its business activities are directly correlated with the FHLBank System's mission, as RWT Financial's current and planned business activities include directly and indirectly acquiring residential mortgage loans from third-party originators and holding those loans on its balance sheet as long-term investments.<sup>3</sup> Since its formation in April 2014, RWT Financial has acquired to hold for long-term investment more than \$500 million of residential mortgage loans and, among other sources, RWT Financial plans to acquire residential mortgage loans sourced through the Federal Home Loan Bank of Chicago's ("FHLBC's") MPF Direct™ product either directly or indirectly through an affiliate. RWT Financial is regulated by the Delaware Department of Insurance and has been a member of the FHLBC since June 2014.

The business activities of Redwood, RWT Financial's parent company, are also consistent with the mission of the FHLBank System, as Redwood and its subsidiaries invest in residential mortgage loans, as well as other mortgage-related assets such as residential mortgage-backed securities ("RMBS")<sup>4</sup>, thereby providing private-sector capital to support homeownership and deepening the liquidity of the residential mortgage finance market. Since January 2010, Redwood and its subsidiaries have acquired more than \$20 billion of residential mortgage loans and RMBS to hold as investments or for subsequent sale or securitization.

With respect to the risks that captive insurance company members may present to the FHLBank System, there are several important factors relating to RWT Financial that mitigate the safety and soundness concerns that the NPR only very briefly raises and explains. Those mitigants include the structure and operations of RWT Financial, the terms of its licensure under applicable state law, ongoing state insurance regulatory oversight, the FHLBC application process, the terms under which RWT Financial can obtain advances from the FHLBC, and ongoing review by the FHLBC of the financial condition, activities, collateral, and membership of RWT Financial.

Other captive insurance companies may present similar safety and soundness concerns and mitigants or, due to differences in form, function, or business activities, may present different concerns and/or mitigants. Regardless, the NPR's "one size fits all" approach of wholly excluding captive insurance companies from FHLBank membership fails to comport with the underlying statutory authority set forth in the Federal Home Loan Bank Act ("FHLB Act")<sup>5</sup> and, if implemented, would ultimately be to the detriment of the FHLBank System. The proposed changes in membership eligibility would exclude an entire category of financial institutions that can further the FHLBank System's mission by promoting a more efficient and liquid residential mortgage finance market that ultimately benefits homeowners and the entire U.S. residential housing market.

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<sup>3</sup> In addition to investing in residential mortgage loans, RWT Financial provides certain insurance to its parent company, Redwood, that is generally not available in the marketplace. RWT Financial earns premiums from, and has reserves relating to, this current insurance coverage.

<sup>4</sup> The FHFA recognizes the importance of mortgage securitization to the mission of the FHLBank System through a provision in the NPR that broadens the definition of "home mortgage loans" to include all types of mortgage-backed securities that are fully backed by first mortgage loans secured single or multi-family property or by other securities that are fully backed by such loans. *See* NPR, at 54854.

<sup>5</sup> The Federal Home Loan Bank Act, 12 U.S.C. §§ 1421-1449 (1932), contains broad and inclusive language regarding membership and the FHLBank System has a long history of expanding, not restricting, membership. The FHLB Act specifically states that "any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, community development financial institution, or any insured depository institution, shall be eligible to become a member of a Federal Home Loan Bank..." *See* 12 U.S.C. § 1424(a)(1) (emphasis added).

## Executive Summary

We are aware of numerous comment letters responding to the NPR that have been submitted to the FHFA that are critical of the proposed changes to FHLBank membership regulations, particularly those concerning captive insurance companies. Rather than simply reiterate those comments, our letter focuses on several areas where we believe our thoughts and experience may provide an additional and valuable perspective to consider prior to implementing what we and many others believe to be an ill-conceived and unnecessary proposed change to FHLBank membership regulations.

1. The NPR Raises Mission-Related Concerns with Captive Insurance Company Membership. The NPR indicates that there are mission-related concerns with captive insurance company membership in the FHLBank System, and concludes that the categorical exclusion of captive insurance companies from the FHLBank System is the appropriate action to address these concerns.

- RWT Financial's Business Activities Strongly Support the FHLBank System's Mission. The review we provide in this letter of RWT Financial's business and operations demonstrates that a captive insurance company's business and operations can be consistent with and strongly supportive of the FHLBank System's mission. The exclusion of all captive insurance companies from the FHLBank System is a short-sighted approach that does not take into account the continually evolving nature of the residential mortgage finance market. If implemented, the NPR would ultimately be counterproductive to the mission of the FHLB System and would not serve to benefit homeowners or the housing market.

2. The NPR Makes Generalizations About Captive Insurance Companies. The NPR incorrectly makes broad assumptions and generalizations about the structure and operations of captive insurance companies that are members of, or may seek membership in, the FHLBank System.

- A Review of RWT Financial Demonstrates that the NPR's Generalizations are Incorrect. The review we provide in this letter of RWT Financial's structure and operations should help to promote an understanding of why all captive insurance companies are not the same and why the NPR's "one size fits all" approach of excluding all captive insurance companies from FHLBank membership is neither necessary nor appropriate.

3. The NPR Raises Safety and Soundness-Related Concerns with Captive Insurance Company Membership. The NPR raises safety and soundness-related concerns associated with captive insurance company members of the FHLBank System and concludes that the manner to address those concerns is for captive insurance companies, as a broad category, to be prohibited from obtaining and retaining FHLBank membership.

- A Review of RWT Financial's Membership Application Process Demonstrates that Existing Authority and Process Can Address Safety and Soundness Concerns. We provide a review in this letter of RWT Financial's status as an insurance company regulated by the Delaware Department of Insurance, the process that RWT Financial went through in applying for membership in the FHLBC, and the ongoing process of RWT Financial remaining a member in good standing with access to advances from the FHLBC. We believe this review provides reassurance that existing insurance regulatory oversight, the existing FHLBank System membership regulations and application process, and the FHLBC's ongoing monitoring and review of its members and the collateral they pledge to obtain advances are well-designed and can readily identify and address safety and soundness issues associated with captive insurance company members. These current robust and effective processes obviate the need for a "one size fits all" approach that would prohibit all captive insurance companies from FHLBank membership.

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Set forth below is a further discussion of each of the topics outlined in the Executive Summary above. We believe that the information and analysis provided in this letter should aid in understanding that a captive insurance company such as RWT Financial can be strongly supportive of the FHLBank System's mission in a continuously evolving residential mortgage financing market. We also hope to clarify that many of the generalizations made in the NPR about captive insurance companies are inaccurate, especially with respect to RWT Financial.

Furthermore, the discussion below should illustrate, through a review of RWT Financial's status as a regulated insurance company under the Delaware Department of Insurance, a review of its recently completed membership process, and a review of the ongoing oversight by the FHLBC of RWT Financial's financial condition, access to FHLBC advances, and collateral pledged to secure those advances, that the existing membership regulations and procedures are appropriately designed to evaluate and address safety and soundness-related issues that may arise with respect to any particular captive insurance company's membership in the FHLBank System. Ultimately, we believe that a review of all of these matters as they relate to RWT Financial demonstrates that a categorical exclusion of captive insurance companies from the FHLBank System is unnecessary and inappropriate.

**1. The NPR indicates that there are mission-related concerns with captive insurance company membership in the FHLBank System, and inappropriately concludes that the categorical exclusion of captive insurance companies from the FHLBank System is the most appropriate remedy available to address these concerns.**

A review of RWT Financial's business and operations demonstrates that a captive insurance company's activities can be directly consistent with and supportive of the FHLBank System's mission. Pursuant to the FHLB Act, the FHFA has determined that the mission of the FHLBank System includes the provision of financial products and services to member institutions that assist and enhance those institutions' capabilities to provide financing to homeowners.<sup>6</sup> Insurance company members have contributed significantly to fulfilling the mission of the FHLBank System since passage of the FHLB Act in 1932 and FHLBank membership has included captive insurers for more than 20 years.

Looking specifically to RWT Financial, in the time since its formation (i.e., since April 2014), it has acquired to hold on its balance sheet as long-term investments more than 800 residential mortgage loans. In acquiring these loans, RWT Financial has provided over \$500 million of liquidity to third-party residential mortgage originators through the use of advances from the FHLBC and funds provided by its parent company, Redwood. Loans that RWT Financial has acquired and pledged as collateral for advances from the FHLBC have an overall weighted-average interest rate of approximately 3.9%, an overall weighted-average loan-to-value ratio (at origination) of approximately 67%, were made to borrowers with a weighted-average FICO score (at origination) of approximately 776, and include loans to first-time homebuyers. We believe that this type of long-term investing in residential mortgage loans adds liquidity to the marketplace and is directly supportive of the FHLBank System's mission. Future business plans of RWT Financial include, among other things, acquiring loans through the FHLBC's MPF Direct™ product (discussed further below), deepening the ability of the FHLBC to provide residential mortgage liquidity to other members of the FHLBank System.

In addition, although RWT Financial does not act as a funding conduit through which a parent or affiliate of RWT Financial gains access to FHLBank advances (discussed further in Section 2 below), it is worth noting that the business activities of RWT Financial's parent company and affiliates are also

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<sup>6</sup> See 12 C.F.R. § 1265.2.

generally supportive of the FHLBank System's mission. As noted at the outset of this letter, since January 2010, Redwood and its subsidiaries (including RWT Financial) have acquired more than \$20 billion of residential mortgage loans and RMBS to hold as investments or for subsequent sale or securitization (including approximately 35,000 individual residential mortgage loans), thereby acting as an important source of liquidity to the residential mortgage market.<sup>7</sup> In particular, Redwood Residential Acquisition Corporation ("Redwood Residential"), an affiliate of RWT Financial, recently announced jointly with the FHLBC the establishment of MPF Direct™, a new mortgage purchase product offered by the Mortgage Partnership Finance® Program. MPF Direct™ allows members of a FHLBank that participate in the MPF Program to deliver eligible residential high-balance mortgage loans through the MPF Program's operational platform to subsidiaries of Redwood. In addition, Redwood recently announced a risk-sharing arrangement between Redwood Residential and Fannie Mae, under which Redwood Residential commits to absorb the first one percent of credit losses on a pool of conforming residential mortgage loans it sells to Fannie Mae. In short, mortgage REITs, such as Redwood, and their subsidiaries are playing an important role as providers of liquidity and private-sector risk capital to a mortgage finance system that continues to evolve in a post-crisis environment.

We believe that even this brief review of RWT Financial's business and operations can serve as an example of why any mission-related justification for categorically excluding all captive insurance companies from the FHLBank System is misplaced. Any such exclusion fails to fully understand the role that a captive insurance company, such as RWT Financial, can play in the continually evolving residential mortgage finance market. To implement such a rule would be short-sighted and counterproductive to the mission of the FHLB System.

**2. The NPR's broad assumptions and generalizations about the structure and operations of current or prospective captive insurance company members of the FHLBank System are inaccurate in the case of RWT Financial and do not represent a sound rationale for the proposed "one size fits all" approach of excluding all captive insurance companies.**

The NPR makes various broad assumptions and generalizations about captive insurance companies, including those highlighted below. In the case of each of these assumptions, we review details of RWT Financial's structure and operations that should help to promote an understanding of why all captive insurance companies are not the same, why the NPR's generalizations are inaccurate, and why the NPR's "one size fits all" approach of excluding all captive insurance companies from membership is not necessary or appropriate.

- **The NPR states that captive insurance company members of the FHLBank System are self-insuring vehicles where "the primary, or sole, motivation for those captives being created 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."<sup>8</sup>**

In the case of RWT Financial and Redwood, this generalization does not apply and is inaccurate. When RWT Financial acquires residential mortgage loans to hold as investments on its balance sheet, it funds the purchase of those loans using a combination of advances from the FHLBC, funds received from its parent, Redwood, and its own retained earnings. Consequently, and quite in contrast to the

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<sup>7</sup> At September 30, 2014, more than 80% of Redwood's consolidated assets consisted of residential mortgage loans or RMBS.

<sup>8</sup> NPR, at 54854.

generalizations made in the NPR, Redwood is a provider of funding to RWT Financial, its captive insurance subsidiary, through equity contributions and inter-company loans.<sup>9</sup>

RWT Financial's business plan includes acquiring residential mortgage loans from third-party originators, both directly and indirectly through an affiliate, Redwood Residential. Regardless of whether a loan is acquired by RWT Financial directly or indirectly through an affiliate, the end result is the same: RWT Financial funds that purchase using a combination of advances from the FHLBC, funds received from its parent company, Redwood, and its own retained earnings. In purchasing a residential mortgage loan, those combined funds flow to the third-party originator of the loan, allowing it to then originate additional residential mortgage loans. Similar to many FHLBank members that are not captive insurance companies, it is through this flow of funds that RWT Financial makes its primary contribution to supporting the FHLBank System's mission of providing liquidity to the residential mortgage market. Rather than being redirected to fund the operations of its parent company, FHLBC advances made to RWT Financial ultimately flow to a third-party originator of residential mortgage loans and then on to homeowners to finance homeownership.

The NPR expresses concern that captive insurance company members of the FHLBank System are "acting as conduits to provide advances to affiliated companies that are themselves ineligible for [FHL]Bank membership" to "fund their business operations."<sup>10</sup> As noted above, RWT Financial is not funding the business operations of its parent company or other affiliates. Instead, it is obtaining advances to fund its own acquisition of residential mortgage loans to hold as long-term investments on its own balance sheet. Rather than containing concrete examples of captive insurance company members inappropriately providing advances to affiliated companies to fund their business operations, the NPR merely conjectures that such activities are occurring and that they are synonymous with a specific category of FHLBank members – namely, captive insurance companies. Regardless, this generalization is not accurate with respect to RWT Financial.

- **The NPR states that, with respect to captive insurance subsidiaries of REITs, FHLBanks "do not 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" and that "[a] captive's financial condition could worsen without the Bank's knowledge due to the relative unavailability of objective financial information and ratings as compared to other insurers and depository institutions."**<sup>11</sup>

In the case of RWT Financial and Redwood, we simply believe that this generalized statement is inaccurate. Redwood is a publicly-traded company (NYSE: RWT) that files detailed and publicly-available quarterly and annual reports with the Securities and Exchange Commission ("SEC") and

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<sup>9</sup> Aside from repayment of intercompany debt, any funding provided by RWT Financial to its parent company, Redwood, would take the form of a dividend or other return of capital. Any dividend or other return of capital is regulated by the Delaware Department of Insurance, would be funded by profits of RWT Financial from its business and operations or from RWT Financial's equity capital (rather than from the proceeds of advances from the FHLBC), and could only be made if in compliance with the financial covenants and other terms of the advances agreement and related documents in place with the FHLBC. We believe this type of funding by a FHLBank member to its parent company is typical of most bank and insurance company members of the FHLBank System that are held within a holding company structure.

<sup>10</sup> The NPR seems to admit that this concern is also present with respect to certain banks and non-captive insurance companies, however, it does not propose excluding those institutions from membership in the FHLBank System. See NPR, at 54853.

<sup>11</sup> NPR, at 54854.

publicly files with the SEC annual financial statements audited by an independent registered public accounting firm. Furthermore, Redwood is required to file Current Reports on Form 8-K promptly following, among other things, certain material adverse events. RWT Financial is also required to provide annual financial statements to the FHLBC that are also audited by an independent registered public accounting firm. In addition, Redwood and RWT Financial provide other periodic reports and compliance statements to the FHLBC under the terms of the advances agreement and related documents (“Advances Facility”) in place with the FHLBC. In short, we believe that the FHLBC has access to the same financial condition and other information relating to RWT Financial and its parent company, Redwood, as regulators of insurers and depository institutions have to the institutions they regulate.

We believe that the meaningful financial condition and other information provided and available to the FHLBC regarding Redwood and RWT Financial equals or exceeds that which is available from other members in the FHLBank System.<sup>12</sup> The broad generalization that the NPR makes in this regard with respect to captive insurance companies is inaccurate in the case of RWT Financial and should not serve as the justification for making captive insurance companies categorically ineligible for FHLBank membership. The suggestion in the NPR that captive insurance company members inherently pose a threat to the FHLBank System due to perceived lack of access to, or knowledge of, the financial condition of the captive insurer or its parent company ignores a myriad of existing disclosure requirements and regulatory authority that provide for robust oversight and information reporting. To the extent financial or other information should be provided in a more standardized format, in more detail, or on a more frequent schedule, then the authority and mechanisms already exist to require captive insurance company members to do so – and RWT Financial would, of course, be responsive to any such requirements.

- **The NPR states that “the financial condition of [a] captive, which operates to serve the parent, rather than its own financial self-interest, may deteriorate rapidly due to the actions of the parent... [and] the parent might decline to provide financial support, or to provide additional collateral, in cases of financial distress.”<sup>13</sup>**

Although this statement could just as well apply to any type of bank or insurance company that has a parent holding company, the NPR singles out captive insurance companies as the locus of concern with respect to these issues. Regardless, in the case of RWT Financial and Redwood, this generalization does not apply and is inaccurate. As a condition of extending advances to RWT Financial, the FHLBC specifically required Redwood to provide a guaranty of the repayment of all advances made to RWT Financial. As a result, Redwood is legally obligated to support RWT Financial and the FHLBC has direct recourse against Redwood for any failure of RWT Financial to repay advances. Redwood’s guaranty for RWT Financial’s obligations is a commitment that strengthens the safety and soundness of RWT Financial’s membership in the FHLBank System.

As a result of its guaranty, Redwood has neither the incentive nor the option to decline to financially support RWT Financial for obligations related to its membership in the FHLBC. The broad generalization the NPR makes in this regard with respect to captive insurance companies is not accurate in the case of RWT Financial. Rather than exclude all captive insurance companies from membership due to this concern, a more appropriate response would be to require a parent guaranty in cases where it is

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<sup>12</sup> Publicly-traded FHLBank System members and/or publicly-traded parent companies of these members would have similar reporting to Redwood. Non publicly-traded depository members of the FHLBank System are also subject to similar quarterly reporting requirements in the form of Federal Deposit Insurance Corporation (“FDIC”) call reports.

<sup>13</sup> NPR, at 54854.

merited by company-specific safety and soundness concerns and, thereby, eliminate the risk that the parent company might decline to financially support a subsidiary that is an FHLBank System member.

- **The NPR states that a captive insurance company’s “balance sheet may reflect non-diversified risk if its underwriting activities are narrowly prescribed by the parent [company].”<sup>14</sup>**

Setting aside the fact that this statement could equally apply to any type of insurance company held within a holding company structure, this generalization is fundamentally inaccurate in suggesting that RWT Financial presents more risk to the FHLBank System than other non-captive insurance company members. The scope of RWT Financial’s insurance underwriting activities is strictly overseen by its insurance regulator, the Delaware Department of Insurance, and has been reviewed with the FHLBC. Risk presented by the degree of diversification of RWT Financial’s underwriting activities is addressed through reserving requirements imposed by its insurance regulator, as well as through financial covenants and other terms set forth in its Advances Facility with the FHLBC.<sup>15</sup>

Moreover, because RWT Financial’s insurance activities are limited to providing insurance to its parent, Redwood, to the extent insurance claims are paid by RWT Financial, all of the proceeds of those claims are available to repay advances to the FHLBC under the guaranty provided to FHLBC by Redwood. Consequently, we believe that RWT Financial’s insurance underwriting activities, even though narrowly prescribed, present less risk to the FHLBank System than those of a non-captive insurance company, regardless of the relative breadth of scope of their respective insurance activities.

In the absence of any concrete facts or examples, the NPR implies this issue is somehow applicable only to captive insurers as a class of financial institutions and fails to explain why the same issue is not present with non-captive insurance company members of the FHLBank System. Moreover, in the case of RWT Financial, risks from insurance underwriting are mitigated by the parent company’s guaranty of all advances made by the FHLBC, as explained above. Consequently, an exclusionary membership rule that discriminates against captive insurance companies should not be put into place based on these types of unsupported assertions contained in the NPR.

- 3. Existing FHLBank membership regulations and processes are well-designed to identify and address safety and soundness-related issues associated with captive insurance company members and the NPR’s proposed approach of excluding all captives from membership is unnecessary to address these concerns. If implemented, the proposed membership regulations would needlessly exclude an entire category of statutorily permitted members that can further the FHLBank System’s mission as the mortgage finance market continually evolves.**

RWT Financial’s processes for formation and licensure as a Delaware captive insurer and its process for applying for membership in the FHLBC are examples that should provide reassurance that existing membership processes and regulations are well-designed to identify and address safety and soundness issues associated with captive insurer members, obviating the need for a “one size fits all” exclusionary approach for captive insurance companies.

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<sup>14</sup> NPR, at 54854.

<sup>15</sup> Captive insurance companies such as RWT Financial must possess and maintain a statutorily prescribed level of capital and surplus and the Delaware Insurance Commissioner may prescribe additional capital and surplus requirements based on the captive insurance company’s type, volume, and nature of insurance transacted. *See* 18 Del.C. §§ 6905(a)(7), (b).



The FHLBC staff conducted a very vigorous and thorough process in connection with evaluating RWT Financial's application for FHLBC membership and establishing RWT Financial's Advances Facility. There was a disciplined approach throughout the process with regard to understanding the business and operations of RWT Financial, the legal and regulatory environment in which it would operate, including regulation by the Delaware Department of Insurance, the relationship with its parent company and affiliates, the manner in which it would use FHLBC advances, and the appropriate covenants and guarantees that should be in place among RWT Financial, Redwood, and the FHLBC. Recounting the entire process, which was exhaustive, is prohibited by the time and space available, but we do want to illustrate how the existing processes and regulations thoroughly addressed the concerns only briefly articulated in the NPR. To that end, we offer the following examples of how the safety and soundness-related concerns expressed in the NPR were addressed during RWT Financial's formation and the membership application process.

- Applicable Insolvency Regime. During our application process, the FHLBC staff focused on ensuring that applicable insolvency laws would not only protect the FHLBC's security interest in loans pledged as collateral for advances to RWT Financial, but that the FHLBC would be able to quickly liquidate that collateral and apply the proceeds to extinguish outstanding advances, thereby reducing market risks that can accompany any delay resulting from the imposition of any type of "bankruptcy stay." The State of Delaware, for example, where RWT Financial is licensed as a captive insurer, has enacted a statute that provides special protections to FHLBanks related to advances they make to their Delaware-licensed insurance company members.<sup>16</sup> Accordingly, advances made by the FHLBC to RWT Financial are certainly safer, all other things being equal, than advances made to other insurance company members licensed or chartered under state laws that do not include these special protections afforded to the FHLBanks.
- Direct Pledge of Mortgage Loans/Use of Custodian. As part of the establishment of RWT Financial's Advances Facility, the FHLBC required that advances be collateralized by mortgage loans held directly on RWT Financial's balance sheet, and expressly required that the FHLBC's security interest in those mortgage loans be perfected through possession of that collateral by a custodian acting for the FHLBC. In addition to the safety and soundness aspect of these requirements (which ensure that the insolvency law posture of RWT Financial is favorable to the FHLBC), it also provided assurance to the FHLBC that RWT Financial's business operations would include a focus on directly investing in residential mortgage loans, furthering the mission of the FHLBank System.
- Parent Guaranty. As a precondition to extending any advances to RWT Financial, FHLBC required a parent-level guaranty of those advances. This guaranty enhances the safety and soundness of advances to RWT Financial and, as noted in several instances above, aligns the interests of Redwood and the FHLBC with respect to RWT Financial satisfying its obligations to the FHLBC.
- Financial & Information Covenants. When entering into the Advances Facility with RWT Financial, the FHLBC staff imposed strong financial covenants with respect to both RWT Financial, and its parent, Redwood, thus ensuring that both the captive insurance company member and its parent guarantor would maintain a level of financial strength that is appropriately correlated with the captive insurer's access to FHLBank advances. Furthermore, the FHLBC

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<sup>16</sup> See, e.g., 18 Del.C. § 5904 (appointment of a receiver not an automatic stay on an FHLBank exercising its rights as secured creditor) and § 5925 (exclusion of ordinary FHLBank transactions from receiver's powers to void transactions).

required information reporting covenants that provide the FHLBC with robust information and examination rights.

In addition to the application process described above, the FHLBC has used its authority and rights under the Advances Facility and existing regulations to regularly review and monitor the financial condition of RWT Financial and its parent company, Redwood, as well as to review the mortgage loans pledged as collateral for advances to ensure the ongoing safety and soundness of RWT Financial's membership and access to advances.

The foregoing examples all illustrate that the existing authority given to individual FHLBanks under the FHLB Act can be used, and is, in fact, being applied in the case of RWT Financial, in deciding how to safely and soundly transact with a captive insurance company member. In doing so, we believe the FHLBC is carrying out its obligation to exercise discretion and only issue advances that it determines "it may safely make" after review of, among other things, the credit underwriting factors set forth in applicable regulations.<sup>17</sup> As a result, it is unnecessary to address these safety and soundness-related concerns through the unnecessarily broad mechanism that the NPR proposes – the wholesale elimination of captive insurance companies from FHLBank membership.

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The review in this letter of RWT Financial's business and membership in the FHLBC demonstrates that categorically excluding captive insurance companies from FHLBank membership is not in the best interest of the FHLBank System. Furthermore, existing regulations and processes provide the appropriate authority and means to address the concerns raised in the NPR with respect to captive insurers. Mission- and safety and soundness-related concerns relating to membership in the FHLBank System should be raised and addressed, but the means and manner for addressing those issues should be on a reasonable and appropriate case-by-case basis that considers the merits and operations of each individual current or future captive insurance company member.

We agree with the FHFA that "Congress intended to reserve the benefits of [FHL]Bank membership...for institutions that are likely to use those benefits to fulfill the primary purposes of the [FHLB] Act."<sup>18</sup> Applying that standard, surely an eligible insurance company member<sup>19</sup> such as RWT Financial should not be prohibited from membership based on an unnecessarily broad and exclusionary approach to captive insurance companies. This letter clearly demonstrates that RWT Financial responsibly contributes to fulfilling the mission of the FHLBank System on a safe and sound basis. Please also consider that as the nation's housing finance system continues to evolve on a large scale, we should all be concerned about the unintended consequences that could result from categorically excluding certain types of otherwise eligible financial institutions from participating in and contributing to the mission of the FHLBank System and the efficiency and liquidity of the residential housing finance market.

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<sup>17</sup> See 12 C.F.R. § 1266.4.

<sup>18</sup> NPR, at 54850.

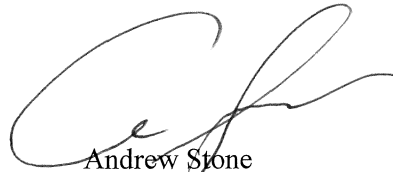
<sup>19</sup> Captive insurance companies undoubtedly meet the FHLB Act's statutory requirements for membership and we believe that implementing the NPR's provisions relating to captive insurers would be to proceed against not only the plain language of the statute, but also against the Congressional intent behind it.

We appreciate your consideration of our viewpoints and comments on the NPR. Please do not hesitate to contact us using the contact information first set forth above if you would like to further discuss Redwood, RWT Financial, or any aspect of this letter.

Respectfully submitted,



Christopher Abate  
Chief Financial Officer,  
RWT Financial, LLC



Andrew Stone  
General Counsel,  
Redwood Trust, Inc.