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January 9, 2015

Alfred M. Pollard, General Counsel
Attention: Comments/RIN2590-AA39
Federal Housing Finance Agency
400 Seventh Street, SW, Eighth Floor
Washington, DC 20024

Re: Notice of Proposed Rulemaking and Request for Comments – Members of Federal Home Loan Banks (RIN 2590-AA39)

Dear Mr. Pollard:

On behalf of **Hatteras Financial Corp.** (“Hatteras”), a mortgage real estate investment trust (“REIT”) based in Winston-Salem, North Carolina, I am writing this letter to express my concerns about the Federal Housing Finance Agency’s (“FHFA”) Notice of Proposed Rulemaking (“NPR”) issued September 12, 2014. We have reviewed scores of responses to the NPR and agree with the consistent recommendation that the FHFA withdraw the proposed rules. We would also like to reiterate some of our objections to the NPR and would like to clarify some of the assertions raised in the NPR that do not square with our understanding or experience.

Hatteras agrees with letters submitted to date requesting withdrawal of the NPR

We recognize the important role the FHFA plays in ensuring the Federal Home Loan Banks (“FHLBanks”) continue to meet the mission established by Congress and we support FHFA actions that protect the housing finance markets and prevent inappropriate access to system liquidity. However, it appears a full spectrum of stakeholders in the activities of the Federal Home Loan Banking system agree that the NPR is negative for the Federal Home Loan Banking system, the housing market, the related financing markets, and affordable housing in the United States. These constituents include:

- 95 members of Congress, including 27 U.S. Senators and 68 members of the U.S House of Representatives;
- The FHLBanks, Council of FHLBanks, and industry executives;
- Commercial and savings banks from large national banks to small community banks;
- Various banking associations including the American Banking Association and state associations;
- Credit unions and related industry associations;
- Community development financial institutions;
- Insurance companies, including stock, mutual and captive insurance companies;
- Current and former financial service industry executives, including former FHLBank executives;
- National insurance associations;
- State insurance regulators;

- Real estate developers, builders, state housing finance agencies, and other organizations focused on housing markets;
- The Mortgage Banking Association, the National Association of Real Estate Investment Trusts and other organizations focused on residential mortgage markets;
- Attorneys and legal experts; and
- Non-profit organizations focused on affordable housing, such as Habitat For Humanity, community housing authorities and non-profit organizations relying on affordable housing.

This diverse group of respondents share similar objections to the NPR. With respect to the proposal to make captive insurance companies ineligible to join FHLBank, they overwhelmingly:

- Believe the NPR is not needed and captive insurance companies further the FHLBank mission;
- Dispute that captive insurance companies pose more risks to the housing market than any other class of members; and
- Believe that, while the FHFA has identified its concerns, the basis supporting these concerns is flawed, the approach of the NPR is not properly balanced and the resolution could be more appropriately addressed through dialogue within the industry.

Further, the respondents believe enacting the proposed rule:

- Creates uncertainty about FHLBank membership eligibility and would limit liquidity provided to the housing markets by insurance companies;
- Undermines the reliability of the FHLBanks as sources of liquidity;
- Harms the FHLBanks by reducing diversification and liquidity;
- Increases the likelihood of instability and volatility surrounding FHLBank advances;
- Harms small credit unions, CFIs and CDFIs that are key providers of funding to smaller communities;
- Negatively impacts FHLBank profitability;
- Reduces FHLBank support of the Affordable Housing Program (“AHP”) and community investment programs;
- Negatively impacts individuals and organizations relying on AHP;
- Is contrary to the plain meaning of the Federal Home Loan Act of 1932 (“FHLB Act”) and is beyond the scope of the FHFA’s authority to usurp Congress’ role in establishing FHLBank eligibility guidelines;
- Is arbitrary in terminating eligibility of a single class of insurance companies;
- Is not appropriate for the FHFA to address at this time as housing finance is currently an important issue in front of Congress and issues impacting housing finance should be coordinated and addressed by Congress; and
- Violates the Administrative Procedures Act.

Hatteras and the liquidity provided to the residential mortgage market

Hatteras is one of the largest REITs focused on the residential mortgage market. Founded in 2007, we have grown to \$2.5 billion of capital and close to \$20 billion of mortgage assets. We

are 100% supported by private capital, primarily from institutional and retail investors. Our strategy is to invest in pools of securities backed by residential mortgages funded primarily through over-collateralized loans. Our business model was developed with an understanding of the wholesale funding markets and keen awareness of the challenges these markets can present during volatile times. We focus on managing interest rate risk and prudently managing the other risks inherent in our business. Our business model has demonstrated durability through volatile funding markets like 2008 and also through multiple U.S. Federal Reserve monetary policy cycles.

Mortgage REITs, such as Hatteras, play an important countercyclical role in providing liquidity to the housing markets. During strong economic times, banks tend to loosen credit and offer attractive funding to the housing market while REITs may have less capacity. Alternately, during slower times when credit reserves and credit losses increase and interest rates decline, banks are likely to tighten lending requirements while mortgage REITs typically have more access to capital, thereby filling that void.

The recent financial crisis confirmed the benefit that REITs, such as Hatteras, provide the housing market, as we had continued access to capital during the downturn. We estimate we have funded well over 200,000 single family homes since we were formed. We are very proud of the liquidity we provide to the mortgage markets and the role we play in facilitating home ownership in the United States.

Hatteras experience not consistent with characterizations in NPR

As a potential future member of a FHLBank, we appreciate the FHFA's role to identify risks related to its members. Hatteras has evaluated forming a captive insurance company and our experience could help address some concerns and clear up some erroneous assertions in the NPR.

- 1. Funding parent company investments not primary rationale for us considering membership.*** Our business model has demonstrated its durability and our core funding strategy does not need to change to be effective. Hatteras already has excess funding capacity and does not need FHLBank advances to fund the mortgage portfolio. FHLBank membership is important for any potential captive insurance company affiliate as it would be unlikely to have access to all the funding alternatives available to Hatteras. Our experience seems at odds with the NPR suggestion that the primary motivation for mortgage REITs is to obtain funding for its parent.
- 2. Captive insurance companies pose no additional risks than other insurance companies.*** The NPR mentions a number of potential safety and soundness concerns relative to other insurance companies. Captive insurance companies are similar to other insurance companies and are subject to the same terms and conditions pertaining to administrative supervision, conservation, rehabilitation, receivership and liquidation. This regulatory oversight and supervision is what Congress intended would determine eligibility. Also, captive insurance companies, while having a relatively short history, have had a lower

rate of failure than other insurance companies and other categories of FHLBank membership.

3. ***Captives are subject to significant oversight and regulation.*** We first evaluated forming a captive insurance company in 2008, and at the time decided to purchase our insurance outright rather than to form a captive insurance company. We are well versed in the requirements and expense versus the benefits that must be considered when making this business decision. These requirements include the comprehensive licensing requirements, capital and surplus standards, annual financial reporting requirements, regular insurance department inspections and examinations and investment restrictions. We continue to consider the benefits of a captive insurance company against the ongoing costs and requirements and limited ability to repatriate capital.
4. ***Affiliate transactions are closely regulated.*** Contrary to the characterization in the NPR that suggests there are specific risks related to transactions between captive insurance companies and their affiliates, transactions between captive insurance companies and their affiliates are subject to the same oversight as transactions between other insurance companies and their affiliates.
5. ***Captive insurance companies are not funding conduits.*** The NPR makes numerous references to captive insurance companies being formed as funding conduits which seems to be a key basis for FHFA's objections. The NPR suggests captive insurance companies are put in place to fund the business operations of its parent. This is inconsistent with our discussions with various FHLBanks. To whatever extent a captive insurance company acts directly as a funding conduit outside the manner of typical insurance operations should be a topic for discussion and debate. The blanket characterization is false and should not be a justification to eliminate an entire class of potential FHLBank members.
6. ***Financial disclosure is comparable to other members.*** The NPR suggests that a captive insurance company's financial condition could worsen due to the relative absence of objective financial information and credit ratings as compared to other insurers. We disagree. While it is true that captive insurance companies generally do not have ratings, this is a function of their focus on affiliated risks. Further, ratings should be a secondary tool used by FHLBanks to monitor a member's financial condition. The primary tools for captive and other insurance companies are comparable in that they are both required to make periodic filings to the state regulators. In addition, parents of captive insurance companies, such as Hatteras, register with the Securities and Exchange Commission ("SEC"), make periodic SEC filings, and are required to disclose any material changes or developments in its business, financial condition and operations, which would include the operations of a captive insurance company.
7. ***Non-diversified risk addressed by regulation and FHLBank risk management.*** The NPR mentions that the captive insurance company's balance sheet may reflect non-diversified risk if underwriting activities are narrowly prescribed by the parent. This issue seems to be well recognized by state insurance regulators and inherent in the requirements related to capitalizing and operating a captive insurance company.

8. ***Overcapitalization reduces risk to FHLBank.*** The NPR seems to suggest that the overcapitalization of the captive insurance company is a problem, which is at odds with our experience with the insurance industry. In addition, we are not aware of the FHFA raising this concern with any other banks or insurance companies. We believe this concern would be a surprise to most insurance companies and regulators.
9. ***Captive insurance companies can further the FHLBank mission.*** Captive insurance companies can only utilize FHLBank advances to the extent they have eligible FHLBank collateral. An advance to a captive insurance company requires mission related assets, or it cannot borrow. We are not aware of any evidence to support the assertion that captive insurance companies threaten the FHLBanks' mission, given the FHFA's current regulatory protections and the individual FHLBank processes, credit policies and procedures and over-collateralization of loans. Captive insurance companies invested in residential housing markets serve to further the mandated mission of the FHLBanking system.

Primary Objections to NPR:

1. ***The NPR discriminates against an important and growing segment of the insurance industry.*** The NPR comments about a small and growing number of captive insurance companies that have become FHLBank members. The increase in the number of captive insurance companies joining as members of the FHLBank should be of no surprise as the number of captive insurance companies has increased while the number of other insurance companies has declined. Many industry participants expect the trend towards less traditional insurance to continue. The FHFA should not create barriers by arbitrarily determining what type of insurance company is eligible or ineligible for membership.
2. ***Limiting access among insurance companies is a significant departure from the intent of the FHLB Act and should be only changed through Congressional action.*** Congress plays the primary role of determining who is and is not eligible for FHLBank membership. In 1932, Congress determined any insurance company shall be eligible to become a member of a FHLBank without reservation or limitation. The NPR does not establish that captive insurance companies are materially different than the insurance companies authorized by Congress to join the FHLBank. Clearly, by making all insurance companies eligible to become a member of the FHLBank, Congress intended to ensure no type of insurance company would be disadvantaged against another. Change in any fundamental aspect of the FHLB Act has always been Congress' purview and it's alone.
3. ***Congress never established restrictions related to the ownership of a potential FHLBank member. The NPR would override Congress and create a dangerous new precedent for affiliates of both banks and insurance companies.*** While the NPR indicates captive insurance companies were not prevalent in 1932, holding companies for both banks and insurance companies were widespread in 1932 having been the subject of

much debate, legislation and regulation during the 25 years prior. The lack of restriction indicates Congress intended for eligibility to rest entirely on the bank or insurance company entity, not on the parent or other affiliates. We also do not believe captive insurance company affiliation with non-members should be particularly relevant to eligibility given the large number of non-regulated affiliates of existing bank and insurance company members of FHLBanks, including a number of bank-owned REITs. While the NPR mentions that other bank and insurance companies have some of the same issues, it defers the issue by stating it may be addressed in the future. This equivocation diminishes previous FHFA rulings that all eligible members be treated equally.

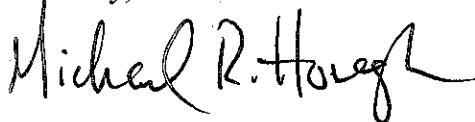
4. **History of insurance company structures support Congressional intent to include all insurance companies including captive insurance companies.** Between mutual insurance companies, insurance companies and other cooperatives that share similar genes, there is ample evidence to suggest Congress did not intend to limit eligibility per the original FHLB Act. Even if not the case in 1932, Congress chose not to provide any limitation even though it addressed membership three times over the past 25 years well after captive insurance companies were prevalent in the United States.
5. **The NPR overturns long standing policies related to insurance company regulation.** Congress has considered and passed on federal regulation of the insurance industry, reaffirming the role of the states in regulating insurance companies, including the ability to define what is and is not an insurance company.

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In conclusion, while we appreciate that the growing membership of captive insurance companies in FHLBanks may create concerns, we disagree that the NPR is the appropriate way to address them. We respectfully request the FHFA withdraw the proposed rulemaking and request prompt action to remove uncertainty surrounding FHLBank eligibility. We believe the FHLBanking system would benefit from a diverse and robust membership that closely shares the purpose and intent of affordable home ownership in the United States.

In the meantime, we support the FHFA in evaluating any concerns and remain available to discuss further.

Sincerely,



Michael R. Hough
Chief Executive Officer
Hatteras Financial Corp.