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Eric M. Raudenbush, Assistant General Counsel
Office of General Counsel
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, DC

Re: RIN 2590-AA39—Members of Federal Home Loan Banks
By electronic submission to www.fhfa.gov/open-for-comment-or-input

Dear Mr. Raudenbush:

Founded in 1968 to understand the problems facing America's cities and to assess the programs of the War on Poverty, the Urban Institute conducts research to understand and solve real-world challenges in a rapidly urbanizing environment. Urban's scholars blend academic rigor with on-the-ground collaboration, teaming with policymakers, community leaders, practitioners, and the private sector to diagnose problems and find solutions.

Founded in 2013 to focus exclusively on the housing finance system, the Urban Institute's Housing Finance Policy Center ("HFPC"), is focused on providing timely, impartial data and analysis that will help policymakers better understand how policy decisions impact the housing finance system and, ultimately, households, communities and the broader economy.

Given the significant role that the Federal Home Loan Banks ("FHLBs") and Real Estate Investment Trusts ("REITs") play in supporting the real estate finance system, several HFPC scholars felt it was important to offer their views on this proposed regulation and are pleased, therefore, to offer this comment letter in response to the Federal Housing Finance Agency's ("FHFA") Notice of Proposed Rulemaking ("NPR") on Members of Federal Home Loan Banks.

As an organization, the Urban Institute does not take positions on policy. Accordingly, this letter reflects the views of three HFPC scholars, Laurie Goodman, the HFPC director, Jim Parrott, a senior fellow, and Karan Kaul, a research associate. The views expressed here are theirs and not those of any organization with which they have been or currently are affiliated, including any REITs. Please note that Laurie Goodman currently sits on the board of MFA Financial, Inc., a self-advised REIT, and Jim Parrott serves as a policy advisor to another REIT.

Introduction

On September 12, 2014, the FHFA, primary regulator of the 12 Federal Home Loan Banks and the 2 government-sponsored enterprises Freddie Mac and Fannie Mae, published a NPR that would significantly revise the requirements by which financial institutions can become and maintain their membership in the FHLB System ("System"). The NPR would alter several regulatory practices in the System, with substantial changes to membership eligibility requirements, and the manner in which financial institutions are approved for FHLB membership. Three key revisions to existing regulation would

1. require each FHLB member to hold at least 1 percent of total assets in first-lien home mortgage loans or securities backed by such loans ("1 percent rule");

2. require ongoing compliance with the 1 percent rule, as well as with the existing statutory requirement that depository institutions, except for community financial institutions (CFIs) with less than $1 billion in assets, hold at least 10 percent of total assets in residential mortgage loans or securities backed by such loans ("10 percent rule"); and

3. define "insurance company" to mean "a company whose primary business is the underwriting of insurance for non-affiliated persons or entities."

The third provision above would effectively prohibit captive insurance companies—whose primary business is to insure their parent companies—from becoming FHLB members. A few REITs—which are currently ineligible for FHLB membership—have recently established captive insurance subsidiaries for the purpose of obtaining access to FHLB advances. The FHFA has expressed concerns about this practice, citing captive insurers' "safety and soundness" and other statutory provisions in the Federal Home Loan Bank Act as key drivers for promulgating this prohibition on captive insurers.

The proposed rule has received over one thousand comments, the vast majority from community banks, credit unions, and trade associations concerned about the effects of ongoing compliance with the 1 percent and 10 percent rules. In contrast, only a small number of comments have addressed the prohibition on captive insurers. Given the lack of attention this provision has received and because we believe a prohibition on captive insurers could significantly affect the mortgage market, we focus our comments exclusively on this aspect of the NPR. Our analysis is based primarily on economic and practical considerations of the rule; we do not analyze the legal issues.

To date, only a few REITs have accessed FHLB advances through captives, and current volumes are low. Without this proposed rule change, however, we believe that REITs' use of this funding source would gradually increase, which would in turn diversify and deepen liquidity in the secondary market. Ultimately, captives' access to FHLB advances would lower costs to borrowers and strengthen the housing finance system. Moreover, prohibiting captives from becoming FHLB members would not necessarily mitigate FHFA's safety and soundness concerns. To the extent such risks exist, they are low, and can be more effectively mitigated through existing regulatory and FHLB risk management practices.

Analysis

Prohibiting captive insurers from becoming FHLB members for safety and soundness reasons raises two basic questions:

1. Does the availability of FHLB advances for REIT captives benefit the FHLBs, their members, or the mortgage market more generally?
2. Can the FHFA's safety and soundness concerns about captives be adequately addressed without banning them from membership?

REIT Captives Support the Mission of FHLBs and Benefit the Larger Mortgage Market

REITS have deep mortgage market focus. According to Federal Reserve Flow of Funds data, mortgage REITs held approximately $545 billion in total assets as of Q3 2014.[1] Approximately $295 billion, or roughly 55 percent, of these assets was in the form of residential mortgages or securities backed by residential mortgages. Total mortgage assets—residential and commercial—composed over 85 percent of mortgage REITs' total assets as of the same period. These numbers are not surprising, given that REITs are required, by statute, to hold at least 75 percent of their assets in, and derive 75% of their gross income from real estate related investments.[2] This almost-singular focus on the mortgage market ensures that REITs' and their captives' business practices and interests remain strongly aligned with the mission[3] of FHLBs—perhaps more so than those of many depository institution and insurance company members.

REITS support the underserved non-QM market. According to recent media reports and other public information,[4] some REITs are building capabilities to provide funding for loans that might not otherwise qualify for traditional financing, including loans that do not meet the qualified mortgage (QM) test. Origination of non-QM loans remains especially tight as lenders tread cautiously in the new "post-QM" lending environment, primarily worried about legal risks of lending outside of QM. This concern is greater for large banks, which face especially high scrutiny from shareholders, investors, regulators, policymakers, and the media, and which therefore may be less willing to originate such loans. The lack of liquidity for non-QM lending has essentially stranded a segment of borrowers who are not necessarily excessively risky. Many borrowers whose debt-to-income ratio exceeds the maximum allowed under QM have a considerable amount of existing equity and other assets, for example. Such people could include relatively low-risk

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[1] Flow tables, *Financial Accounts of the United States, Third Quarter 2014,* Federal Reserve.

[2] Pub. L. 86-779.

[3] According to the FHFA's "Strategic Plan: Fiscal Years 2015–2019," FHLBs' core mission is "to serve as a reliable source of liquidity for their member institutions in support of housing finance and community lending."

[4] Jody Shenn, "Pine River's Two Harbors Now Targets Non-Prime Mortgages," Bloomberg.com, November 5, 2014; and Jody Shenn, "Mortgage REIT Redwood Joins Home Lome Bank in Chicago," Bloomberg.com, June 12, 2014.

borrowers who are self-employed, business owners or the recently retired, and wealthy borrowers with irregular income streams or temporarily high debt.

Many small lenders—most of which are FHLB members—would be willing to extend loans to these borrowers, where they present low to moderate risk, despite their falling outside of QM, because these lenders have closer relationships with their customers, are better equipped to perform manual underwriting, or for other reasons. What they lack is the financial backing to originate such loans at any scale without outside funding. Enter the REITs, which are looking for opportunities to boost their portfolio returns in the face of low returns on agency mortgage-backed securities (due to historically low interest rates) and a dwindling supply of non-agency mortgage-backed securities (MBS). To that end, REITs have established captives to become FHLB members and are building the capability and the operational infrastructure[5] to buy whole loans from originators—especially loans that don't qualify for traditional financing. This creates an entirely new source of funding, particularly useful for the underfunded non-QM segment of the market. While REITs are only starting to build the capability to buy and hold whole mortgage loans, their continued ability to access FHLB advances via captives could be critical to the long-term success of this platform.

Banning Captives from the FHLB System Will Adversely Affect the Mortgage Market and the FHLBs

Access to FHLB advances diversifies REIT funding sources, provides reliable longer-term financing, and benefits the mortgage market. The recent move by several REITs to set up captives in order to access FHLB advances is not surprising given the funding limitations they face in the market. REITs depend heavily on repurchase agreements (repos)—a form of collateralized short-term borrowing, facilitated primarily by Wall Street broker-dealers, which must be rolled over (refinanced) frequently. This allows REITs to leverage agency MBS assets to seven-to-eight times their capital. But it also exposes them to the risk that repo lenders, when concerned about the value of collateral (which happens frequently during market turmoil), will demand a higher interest rate, apply a larger haircut to their valuation of the collateral, or curtail lending altogether. The resulting "pinch" can significantly and sometimes dramatically increase repo funding costs, or decrease the availability of credit lines, making it difficult for repo-reliant borrowers—such as REITs—to obtain new financing or roll over existing repos. While it appears unlikely that the idiosyncratic failure of a single REIT will pose systemic risks, implications for mortgage market liquidity certainly exist if there was a considerable amount of forced selling of MBS as a result of repo market tightening. Therefore concerns about the stability of repo financing,[6] further compounded by increased bank capital requirements,[7] have

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[5] See the "Mortgage Market Opportunity" section on page 2 of Two Harbors Investment's (a mortgage REIT) Third Quarter 2014 Fact Sheet.

[6] See Zoltan Pozsar, "Shadow Banking: The Money View," Working Paper 2014-04 (Washington, DC: US Treasury, Office of Financial Research, 2014).

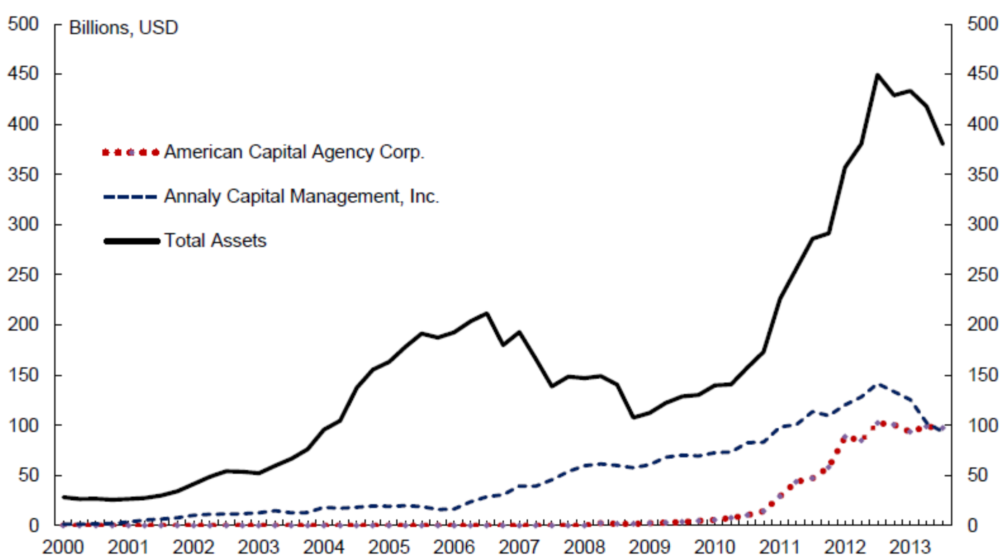
[7] Liz Capo McCormick, "Repo Market Contracts as Dealers Face More Capital Requirements," Bloomberg.com, July 25, 2013.

naturally, and in our view usefully, pushed many REITs to try to diversify their financing sources and access longer-term financing by setting up captives to access FHLB advances. Eventually, this also improves systemic financial stability by reducing the role of repos in transmitting financial shocks.

REITs provide liquidity and funding to the mortgage market. REITs also play a major role in absorbing the supply of MBS and in containing mortgage rates for borrowers (see figure 1)—a role that will only become more important as the Fed and Treasury begin to ease out of the market.[8] Since part of FHLBs' mission is to provide liquidity to their member institutions in support of housing finance, providing a more stable funding channel for captives of REITs is entirely in keeping with that mission. While obtaining FHLB advances via captives is still a new trend and accounts for only a small share of REIT funding, it is nevertheless a valuable funding conduit that should be preserved and expanded as a reliable source of funding for nontraditional mortgages. While all funding sources will undoubtedly shrink during downturns, we believe FHLB advances, because they are longer term in nature, should be less volatile than the broker-dealer facilitated repo market.

FIGURE 1

Total Assets for All Mortgage REITs and the Largest Two, 2000–13



Source: Sabrina R. Pellerin, Steven Sabol, and John R. Walter, "REITs and Their Risks," working paper 13-19R (Richmond, VA: Federal Reserve Bank of Richmond, revised December 2013).

[8] See Michael Fratantoni, "Who Will Own Mortgage Assets?" (Washington, DC: Mortgage Bankers Association, 2014).

REIT captives' access to FHLB advances creates positive externalities for FHLBs and their members.

Membership diversification. REIT captives allow FHLBs to grow and diversify their membership base beyond traditional channels. A more diversified member base should result in a more stable capital position for FHLBs, which should in turn improve their resilience to economic and market shocks. For example, when depository institutions experience an influx of deposits that reduces their demand for advances, REIT-affiliated captive members could be experiencing different market conditions, and could thus act as a complimentary source of demand for advances. Therefore, when assessing the risks posed by REIT captives to FHLBs, the FHFA should not only consider the individual riskiness of REITs' or their captives' businesses, but also evaluate how those risks might correlate with risks posed by other member types. A more diversified risk base should reduce the overall risk profile of FHLBs.

Support for small lenders. REITs have proven expertise in managing real estate investment risks, and, as discussed in the previous section, they could serve as an investor "take-out" for certain mortgages originated by smaller lenders, who often lack a direct line to capital markets. A steady source of REIT funding could also incentivize small lenders to originate more loans or grow volumes, which should in turn increase their profits.

High quality collateral. The vast majority of mortgage REITs' residential mortgage assets are in the form of MBS that are either implicitly or explicitly guaranteed by the US government and are therefore free from credit risk. To the extent REIT captives predominantly pledge these risk-free securities as collateral for FHLB advances, that should further reduce credit risks of the FHLBs.

Unintended consequences possible with overbroad prohibition on captives. Some captive insurers—including non-REIT captives—have been FHLB members in good standing for many years, and have built reliable mortgage origination and servicing capabilities that cater to specific needs of borrowers in small towns and rural areas. Because this NPR would ban all captives, not just captives of REITs, the rule could have unintended consequences for borrowers and businesses in these communities. While we would share a concern about non-mission related captives accessing advances in the future, we also believe those can be addressed more narrowly, without banning all captives.

Current Risks Posed by Captives Are Low; Future Risks Can Be Managed without a Ban

The FHFA's stated safety and soundness concerns pertaining to captives largely stem from (1) limited availability of captives' financial information, (2) potential deterioration of captives' financial condition because of parents' actions, and (3) relatively non-diversified underwriting risk on captives' balance sheets. These are legitimate concerns for any regulator and must not be overlooked. However, as discussed below, risks posed by captives to FHLBs are currently low. The FHFA's concerns about risks rising over time—especially if captives increase their reliance on advances— can be managed through existing FHLB regulatory and supervisory practices with some minor adjustments.

FHLBs' overall exposure to captive insurers is small. Of the total $540 billion[9] in FHLB advances as of September 30, 2014, only $67 billion, or 12 percent, was outstanding to insurance companies (including captives). Additionally, only 129 of the roughly 4,400 FHLB member borrowers, or just 3 percent, were insurance companies as of the same date. While specific data for captive insurer members are not available publicly, anecdotal evidence suggests that captives are a fraction of FHLBs' total insurer members, currently fewer than 20 members systemwide. This suggests that FHLBs' risk exposure to captive insurers is very small. Even if this exposure (and the resulting risk) were to grow over time, we believe FHLBs are well equipped to mitigate those risks effectively.

FHLBs can manage current and future risks using existing tools. FHLBs have wide latitude in determining the appropriate level of overcollateralization and credit limit for each member borrower based on several criteria. These criteria include member financial condition, credit ratings, quality of collateral pledged, method of pledging collateral, and a FHLB's existing exposure to a member.[10] As an example FHLBs are more likely to take physical possession of collateral when lending to insurance companies (as opposed to a written agreement without any collateral transfer when lending to financially strong banks). Likewise, FHLBs may require insurance companies to pledge more collateral for advances than they might require from banks, primarily because of state-level legal uncertainty surrounding claim priority in the event of insurer insolvency. The key point here is that FHLBs have multiple tools in their existing toolkit to manage the kinds of risks described by the FHFA. We believe these existing mechanisms, with minor adjustments, can mitigate these risks effectively.

Strengthening membership approval process for insurers will address many concerns. Concerns about the availability of captive (or parent) financial information appear to be largely rooted in the current regulatory requirement of approving insurers as long as they meet certain minimum capital standards, verified primarily through regulatory filings.[11] In contrast, depository institution applicants undergo a much more rigorous approval process that includes reviews of multiple information sources, such as current and prior regulatory financial reports, audited GAAP financial statements, regulatory exam reports, and outstanding enforcement actions.[12] Consequently, we agree with the FHFA's proposal to strengthen the approval process for insurers (including captives) by requiring FHLBs to review insurer applicants' audited financial statements. To allay further concerns about any adverse impact of parents' financial condition on captives, FHLBs could also require captives to furnish parents' detailed financial and related information. Or, to reduce regulatory burdens, FHLBs could rely on examination and enforcement reports published by State Insurance Commissioners.

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[9] *Federal Home Loan Banks Combined Financial Report for Quarter Ended September 30, 2014* (Washington, DC: FHLB Office of Finance, 2014).

[10] "Federal Home Loan Banks Lending and Collateral Q&A" (Washington, DC: FHLB Office of Finance, 2014).

[11] §12 CFR 1263.16 - Financial condition requirement for insurance company and certain CDFI applicants.

[12] §12 CFR 1263.11 - Financial condition requirement for depository institutions and CDFI credit unions.

Conclusion: FHFA should consider other less invasive alternatives to mitigate its concerns

Whatever legal, regulatory, and supervisory justifications the FHFA might have for prohibiting captive insurers, we urge the Agency to take a more integrated view of the purpose REITs serve within the broader mortgage market, and how captive insurers facilitate that purpose. Financial regulation must strike the right balance between ensuring safety and soundness, and promoting market efficiency. We believe the NPR goes too far by constricting an important development that meets the needs of a changing market, in a way that does not necessarily improve safety and soundness. Therefore, we recommend that FHFA consider the following alternatives to address its concerns:

1. FHLBs have the flexibility to apply higher haircuts to collateral from captives that might pose a greater risk, or to charge a higher interest rate on advances. The FHLBs have not done so yet, but these tools are available. FHLBs' current limits on aggregate borrowing at the member level should also mitigate concerns about risk.

2. FHFA could require FHLBs to review captives' regulatory exam reports and any outstanding enforcement actions brought by State Insurance Commissioners, as well as parents' audited financial information (GAAP or statutory), and any legal actions related to the parents.

3. Where the FHFA is concerned about future captive members abusing the system (such as using FHLB advances for purposes that are not mission related), the Agency could address such issues more narrowly. As one option, the FHFA could work with FHLBs to create "common eligibility criteria" for approving captive insurer member applications, limiting approval to captives whose business is mission related. This will ensure that captives that are deservedly ineligible for membership in one FHLB district are unable to apply for membership in other districts that might seem more welcoming.

4. Recognizing the ongoing role REITs play in the mortgage market, the FHFA may want to work with Congress to amend the statute and allow REITs to become FHLB members directly, without the need for captives.

Sincerely,

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