DRAFT

January 10, 2015

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th St., S.W., Eighth Floor
Washington, D.C. 20024

RegComments@fhfa.gov

Re: Notice of Proposed Rulemaking and Request for Commnets - Membership in Federal Home Loan Banks (RIN 2590-AA39)

Dear Mr. Pollard:

On September 2, 2014, the Federal Housing Finance Agency (FHFA) released for notice and comment a proposed rule (the Proposal) concerning membership in the Federal Home Loan Bank (each, a Bank) System (the System). SABRE Business Insurance LLC (SABRE) appreciates the opportunity to comment on the proposed changes (the Changes) to the current System membership rules in 12 CFR 1263 (the Current Rules).

SABRE is an insurance company subsidiary of ARMOUR Residential REIT, Inc. (ARMOUR) that insures certain business risks faced by ARMOUR. SABRE is authorized to transact insurance business within the State of Montana pursuant to a Certificate of Authority granted by the Montana Commissioner of Securities and Insurance, who is responsible for the regulation and periodic examination of SABRE under the Insurance Code of the State of Montana. ARMOUR is a real estate investment trust (REIT) traded on the NYSE under the ticker symbol ARR.

Together, ARMOUR and SABRE currently hold approximately $15 billion in Mortgage Backed Securities issued or guaranteed by FNMA, FHLMC, and GNMA. ARMOUR attracts private-sector capital to invest directly and through SABRE in US housing finance by purchasing US GSE and GNMA-guaranteed securities. ARMOUR and SABRE thereby improve liquidity and enhance pricing efficiency in our housing finance system. On a human level, this means home financing that is more available and more affordable for more homeowners.

SABRE is an important part of ARMOUR's overall ability to invest private capital in financing US housing. Bank membership is one of several initiatives SABRE is pursuing to increase its role in this regard by diversifying SABRE's funding sources and facilitating SABRE's participation in other mutually beneficial member programs. SABRE was well along in the process of applying for Bank membership until the release of the Proposal effectively halted consideration by the System of applications from insurance companies like SABRE.

As discussed further in our detailed comments, SABRE recommends that the FHFA promptly withdraw the Proposal and leave the Current Rules intact. We have concluded that the Proposal is fatally flawed both in terms of factual foundation and logical analysis. As a result, the Changes would impede, rather than advance, the stated objectives of the Proposal. We have also concluded that no further rulemaking is warranted currently in this area because either the Current Rules adequately address the stated objectives of the Proposal or the improvements occasioned by the Changes are inconsequential as a practical matter.

ARMOUR and SABRE share the goal of the FHFA to foster liquid, efficient, competitive, and resilient national housing finance markets. We are willing and able to risk private capital to that end. SABRE and other insurance companies similarly situated would make good Bank members and their membership would advance the public interest. As members, they could make significant, positive contributions towards the System's mission to provide much needed support for US housing finance.

Thank you for the opportunity to comment on the Proposal. We welcome any questions you have and remain available for further discussion at your convenience.

Sincerely,

James R. Mountain, Manager
SABRE Business Insurance, LLC

COMMENTS

Purpose of the Proposal

The Proposal states that the Changes would "implement more effectively the statutory eligibility requirements." [14][1] The Proposal also concludes that the purpose of the statutory eligibility requirements are to:

- "promote residential lending" [17]
- ensure that "the benefits of Bank membership be used to advance the housing finance mission of the Bank System," [18]
- "support the nation's housing markets by establishing a system of Banks to provide wholesale funds to their member institutions for the purpose of financing those members' residential mortgage lending activities" [20]
- ensure "that the benefits of Bank Membership – such as the ability to obtain advances – accrue to institutions that are engaged in residential mortgage lending" [20]
- ensure "that the benefit of membership, such as favorably priced funding through advances, accrue only to institutions that demonstrate a meaningful commitment to supporting residential housing finance and, therefore, would better ensure that the Banks fulfill their housing finance mission" [21:22]

The Proposal also notes that the Director has statutory duties to, among other things:

- ensure that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets" [19]
- ensure "the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest" [19]
- "issue any regulations, guidelines, or orders necessary . . . to ensure that the purposes of [those statutes] are accomplished" [19]

We agree that these are the appropriate policy goals and the standards by which the efficacy of each element of the Changes should be judged. We conclude that by these standards, most of the Changes are not only ineffective, they are pernicious and counterproductive.

Based on the responses to the predecessor Advance Notice of Proposed Rulemaking and our initial analysis of the over 850 comments received on the Proposal in 2014, it seems that the overwhelming consensus is that the public interest would be best served by the Proposal's prompt withdrawal. We agree with that assessment. We also believe that no further rulemaking in this area is required now. The bases for these conclusions as they relate to each of the primary elements of the Proposal are detailed below.

[1] The numbers in brackets indicate the page number of the Proposal cited.

The "1 percent test" and the "10 percent test"

We conclude that neither of these Changes are required because by design, and based on the empirical evidence, these Changes are intended to and will have minimal effect. For example, "FHFA believes that the minimum level of home mortgage loans should not be so high as to require a significant number of members to materially alter their business and investment practices in order to retain their Bank Membership". [45] And "FHFA's analysis indicated that only a relatively few members would have been out of compliance with an ongoing "10 percent" requirement...." [51]

Another reason that these provisions are unnecessary is that the Bank advance process is already self-regulating. Bank advances must be secured by pledging eligible collateral in excess of the advance amount. Therefore, the "benefits of Bank membership – such as the ability to obtain advances" are only available to members who also have made investments in collateral eligible for advances, such as qualifying home mortgage loans and residential mortgage loans. Moreover, this mechanism is naturally proportional, meaning that members who have made relatively smaller investments in eligible collateral are limited to relatively smaller advances.

These Changes target a problem that does not exist. The Proposal cites as a concern: [21]

> "In recent years, there have been instances in which institutions having only minimal home mortgage loan assets and no plans to originate or purchase any significant amount of such assets have been permitted to become Bank members. Although the *FHFA has found no evidence that this problem is widespread*, it believes that, to the extent the current regulation allows for the possibility that institutions having no significant past or future involvement in home mortgage lending may become and remain Bank members, it does not advance the purposes of the Bank Act." (emphasis added)

If the real, but unstated, concern is that members are obtaining advances against collateral assets that are of the "wrong type" somehow, the appropriate remedy would be to change the collateral eligibility requirements. The Proposal makes no case, or any attempt, to restrict collateral eligible for advances. We do not think any such restriction is currently warranted.

Finally, to the extent that these Changes would influence the behavior of individual affected members, it is likely that the Changes would do more harm than good. Certainly it is possible that the few affected members would slightly increase their investments in qualifying home mortgage loans and residential mortgage loans. It is more likely that the affected members would instead drop their Bank memberships. Banks would need to reduce their liquidity and capital base as they redeemed the stock of departing members. Absent Bank membership, these former members would be less likely to invest in the future in housing finance assets. The incremental impacts would be adverse to interests of the System and reduce the liquidity, efficiency, competitiveness and resiliency of the national housing finance markets.

Definition of "Insurance Company"

The Proposal asserts that "When Congress authorized insurance companies to become Bank members in 1932, the concept of captive insurers was essentially unknown in the United States." [24] That assertion is factually inaccurate. Therefore, the contention that Congress could not have intended for "captive" insurance companies to be included in its plain language authorizing Bank membership by "any . . . insurance company"[2] is equally wrong.

The Proposal cites Strauss,[3] but overgeneralizes by claiming "The first captive insurer in the U.S. is generally thought to have been a subsidiary of Youngstown Sheet and Tube Company that was chartered in Ohio in the 1950s." What the cited passage (below) actually says is just that the name "captive insurance" was invented then, and even that was more adaptation than innovation.

> *"It's All in the Name*
>
> Youngstown Sheet and Tube owned a number of coke and iron mines that supplied its steel mills, guaranteeing as supply of raw materials free from external market forces. These mines were known among the company's executives as 'captive mines.' When Fred Reiss set out to form Steel Insurance for Youngstown Sheet and Tube in 1955, he labeled the insurance subsidiary a 'captive' insurance carrier." [4]

An earlier example of what we would today call a captive insurer appears in 1919 and is described in *Spring Canyon Coal Co. v. Commissioner of Internal Revenue.*[5] The Spring Canyon Coal Co. established its captive insurance program to meet the 1917 Workmen's Compensation Law of Utah. Workers' compensation continues to be a common risk insured by captives. The Spring Canyon Coal Co. program included all of the essential identifying characteristics that we think of today as marking a captive insurance company, such as:

- Insuring business risks of a parent company, using
- Legally separate funds invested for administering and paying claims, run by a
- Third-party specialist manager, operating under
- State supervision and mandated minimum capital requirements.

The fact that the *Spring Canyon Coal* case revolves around the taxation of the captive is irrelevant to the question of Bank membership qualification. Tax status has never been a criteria one way or the other under the Bank Act. For example, the *Revenue Act of 1928*[6] provides that some insurance companies would be tax exempt[7] while others would be taxable.[8] Congress could have easily

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[2] Federal Home Loan Bank Act of 1932 (the Bank Act), as amended. See 12 USC §1424(a)(1).
[3] The Definitive Guide to Captive Insurance Companies 18-22 (2011) AuthorHouse Publishing
[4] *Ibid.*
[5] 43 F.2d 78
[6] Seventieth Congress, Sess. 1, Ch. 852 1928
[7] *Id.* §103 (11), for example
[8] *Id.* §§201-208

distinguished which insurance companies were eligible for membership based on tax status, had that been the intent. By enacting the Bank Act with the phrasing “any . . . insurance company,” Congress clearly intended no such distinction apply. Similarly, both tax-exempt federally chartered credit unions and depository institutions subject to federal income tax are eligible for Bank membership.

Congress has also had ample additional opportunities to rephrase this scoping statement in more limiting ways, and has not. It would be wrong for the Director to usurp that authority. Fortunately, there is no need to because the concerns expressed in the Proposal are not problems.

The Proposal expresses a concern that “captives have been able to become members because the existing regulation does not prohibit it and does not otherwise distinguish between insurance companies that become members to support their own operations and those that become members with the intention of obtaining advances to further the business operations of a parent or affiliate.” [25] This concern erroneously reverses the fundamental flow of funds and capital as between a parent and its subsidiary. All other things being equal, the parent needs to provide capital and funding to its Bank member subsidiary in order for the subsidiary to make the investment in Bank stock required for membership. Also, Bank advances require the subsidiary member to pledge collateral costing more than the amount advanced. So the parent must also provide the subsidiary with capital and funding for that excess value.

Another concern expressed in the Proposal is that REITs are not themselves authorized to become Bank members and permitting insurance company subsidiaries of REITs to become Bank members circumvents Congressional intent to limit membership to certain types of institutions enumerated in the Bank Act. [25:26] This concern is misplaced. The requirements of membership have always run to the member directly and have never previously considered the nature of the ownership of the member. This should not change. For example, equitably applying this notion that a parent must be eligible for membership in order for a subsidiary to be a Bank member would cause the expulsion of several large, current members that are wholly owned subsidiaries of foreign banks.[9]

Finally, the Proposal raises safety and soundness concerns about captive [26:27] including:

- Less availability of information compared to other Members
- Potential instability due to actions, or inactions, of the parent
- Concentration of insurance underwriting risk

These concerns are unfounded because

- Most Bank members are neither public companies nor subsidiaries of public companies, and therefore have much more limited and less timely regulatory requirements to provide information. Most captives are and likely would be subsidiaries of public companies, as is SABRE. Public companies are required to publish financial statement, management discussion and analysis of financial condition and results of operations and changes in

[9] Those foreign parents are not “duly organized under the laws of any State or the United State” as required by 12 CFR §1424(a)(1)(A).

significant risk factors quarterly. This information is required on a consolidated basis including captives and other subsidiaries. ARMOUR also voluntarily publishes significant detailed portfolio information monthly.[10] So it is likely that information available on captives and their parents will be more detailed and timely than what is currently available for most other Bank members.

- Subsidiary companies, including captives, are just as likely to be better capitalized and more stable on a relative basis compared to their parents. Specific parent guarantees may also be used to strengthen, not weaken, a subsidiary. Finally, current stock and overcollateralization requirements provide ample security for Bank advances.
- One of the responsibilities of state insurance regulators is to ensure that all insurance companies maintain adequate capital balances relative to the risks underwritten and policies in force.

The Proposal's analysis of the effect of this Change is also flawed when it claims the "principal effect of this provision would be to prohibit captive insurers from becoming Bank members." (footnote omitted) [23] The definition of "insurance company," by requiring that the "primary business is the underwriting of insurance for nonaffiliated persons or entities" [94] would also exclude from membership every mutual or cooperative insurance company, because their primary business is underwriting insurance for affiliated members. Equitable application to depository institution members would exclude all credit unions, which are cooperatives organized for the benefit of their member depositors. In fact, the Bank Act specifically provides for membership by cooperative banks.[11] Never before in the history of the Bank Act has the nature of a member's ownership or the identity of their insurance or deposit customer base been a gating criteria for Bank membership. It should not become one now.

In our analysis, the principal effects of this Change would be to purposefully reduce the capital base and mission effectiveness of the System by expelling certain current members (which were properly admitted under the Current Rules) and precluding membership by SABRE and other insurance subsidiaries similarly situated. For example, ARMOUR and other REITs focused on investing in mortgage backed securities had aggregate total shareholders' equity of approximately $67.8 billion at September 30, 2014[12] compared to total capital for the System of $46.7 billion[13] at that date. Maintaining the Current Rules would permit the existing member insurance subsidiaries of those REITs to remain in the System and permit SABRE and others similarly qualified and interested to join the System. Adding even a modest fraction of this REIT capital represents a significant opportunity to strengthen the System, thereby improving its ability to foster liquid, efficient, competitive, and resilient national housing finance markets, all of which are in the public interest.

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[10] For example, see Company Updates on www.armourreit.com.

[11] 12 CFR §1424(a)(1)

[12] SNL Peer Analytics using the 35 US companies listed in the "MBS REIT" industry category

[13] FEDERAL HOME LOAN BANKS: Combined Financial Report for the Quarterly Period Ended September 30, 2014, FHLBanks Office of Finance

Bank review of insurance company financial statements

This Change is not required because it would have no practical effect. Each Bank has its own process for credit monitoring that is subject to periodic safety and soundness inspection by the FHFA. The existing general membership "financial condition" eligibility requirement[14] should be seen as simply requiring each Bank to use that existing credit monitoring process as part of evaluating a prospective member's application, which is generally current practice. Adding further specificity to the membership regulations does not advance any cause and creates additional complexity and potential for confusion. It also potentially limits the Bank's ability to adapt to changing circumstances. The Current Rules seem to be adequate and effective as they are. However, if we were to make a change related to the "financial condition" requirement, it would be to entirely remove the existing detailed requirements of 12 CFR §1263.11 and .16.

Principal place of business

This Change is not required because the Current Rules on the subject[15] are complete and adequate to implement the location membership requirement of the Bank Act.[16] These Changes would not foster liquid, efficient, competitive, and resilient national housing finance markets, or be in the public interest. Artificial barriers to membership, such as these Changes, inhibit competition and fundamentally represent a restraint of trade. Efficiency and market liquidity are enhanced when business counterparties are allowed more, rather than less, freedom to seek each other out and agree on mutually beneficial terms of association. To the extent these changes would have effect at all, their effect would be to needlessly limit that beneficial freedom of association.

The Proposal raises the concern that an insurance company member might not conduct business operations from its "home office" in its state of domicile. For example, the Proposal sets as a standard: [72]

> "Thus, in order for an insurance company or CDFI member or applicant for membership to have its "principal place of business" at a particular location the institution must actually conduct business at that location and the activities conducted at that location should be greater in some respect than at any of its other business locations.
>
> . . . . Because an approach that looks solely to the state of domicile . . . would allow for the possibility that an insurance company or CDFI could be deemed to have its <u>principal place of business</u> at a location at which it has <u>no place of business</u> . . . ." (emphasis in original)

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[14] 12 CFR §1263.6(a)(4), which applies to all applicants for Bank membership the requirement of 12 USC §1424(a)(2)(B)
[15] 12 CFR §1263.18(b) and (c)
[16] 12 USC §1424(b)

This concern is unfounded because the state insurance laws under which insurance companies are chartered require more business nexus than a "mere legal presence" [70] or "no place of business." Maintaining good regulatory standing to conduct insurance operations is the most elemental and existential "business" that an insurance company does. It is the foundation upon which all other business rests. In that regard, the state of domicile for an insurance company also meets the test of being "greater in some respect than at any of its other business locations." For example, SABRE is domiciled in Montana, and therefore required to:

- Have one or more directors that are Montana residents
- Hire an insurance specialist located approved by the Montana Commissioner to administer the insurance aspects of our business
- Hire an independent accountant approved by the Montana Commissioner to conduct an annual examination of our financial statements and internal controls
- Have our policy reserves certified by an actuary approved by the Montana Commissioner
- Pay taxes to the State of Montana based on the total value of premiums written
- Keep books and records physically located in Montana and be subject to potential examination by the Montana Commissioner
- Conduct one or more of its board meetings in Montana
- Keep minimum liquid capital on deposit in bank chartered by the State of Montana or approved by the Montana Commissioner

No other state or location in which SABRE does business demands similar attention or involvement by SABRE or its management. The captive insurance company laws of other states are likely similar. By comparison, the Proposal also acknowledges that the "principal place of business" requirement for depository institution is only "a branch office from which some banking business will be conducted, which would satisfy the revised regulation." [70] The insurance activities described above clearly equals or exceeds the level of "some business," which standard should be applied equitably.

The idea that a company's "principal place of business" represents a single physical location is also becoming increasingly outdated. We observe that depository institutions are increasingly using mobile applications, cloud computing, automated telephone response systems and distributed call centers to eliminate physical branches in favor of online and telephone presence. Certain depository institutions even proudly advertise that they have *no* branches and operate entirely online and by telephone. The Current Rules' focus on the state of domicile to determine the appropriate Bank for membership purposes will be a more a durable and reliable regulatory approach as members' operations become more "virtual" and less "physical."

The Proposal cites the U.S. Supreme Court decision in Hertz v. Friend[17] as the guiding light principal for this Change. [71] However, we believe that the Proposal's analysis of Hertz is flawed for several reasons and this Change suffers fatally as a result.

[17] 559 U.S.77 (2010)

In reviewing history relevant to "principal place of business," the Court noted "In 1928 this Court made clear that the 'state of incorporation' rule was virtually absolute. . . . Subsequently, many in Congress and those who testified pointed out that this interpretation was at odds with diversity jurisdiction's basic rationale . . . . Although various legislative proposals . . . were made . . . [in 1932] none of these proposals were enacted into law." From this history, it is clear that in the minds of the legislators at the time of the original passage of the Bank Act, "principal place of business" where a member or applicant would be a "corporate citizen" for purposes of Bank membership would be the place of domicile consistent with the Current Rules,[18] which require no further conforming change.

Continuing with the history cited in Hertz, "Subsequently, in 1958, Congress both codified the courts' traditional place of incorporation test and also enacted into law . . . 'principal place of business' language." Both the Court and the Proposal cite 28 USC 1332(c)(1) as the example language. The Court then goes on to define the "principal place of business" as the "nerve center" which is the "place of actual direction, control and coordination. . . ." The Current Rules already fully embody the "nerve center" approach[19] and require no further conforming change. More importantly, the two substantive Current Rules already perfectly reflect the comparable portions of 28 USC 1332(c)(1), which provide equivalent, parallel paths to state corporate citizenship for an insurer in

> "(B) every State and foreign state by which the insurer has been incorporated; and
> (C) the State or foreign state where the insurer has its principal place of business"

The proposed addition of 12 CFR §1263.19(f) would add needless complexity by introducing exactly the type of vague, multifactor test that the Court eliminated in Hertz. One of the foundational tenants of the Court's decision in Hertz is that "Administrative simplicity is a major virtue in a jurisdictional statute," citing Scalia's concurrence in Sisson v. Ruby[20] "eschewing 'the sort of vague boundary that is to be avoided in the area of subject-matter jurisdiction whenever possible.'" Fortunately, here it is easily avoided – just leave the Current Rules intact.

On the other hand, if the Director insists on rewriting history to focus solely on the "nerve center" test for "principal place of business," the proposed Changes do not accomplish that objective. To do so, not only should the proposed 12 CFR §1263.19(f) not be added, the existing 12 CFR §1263.18(b) would need to be deleted. All decisions about "principal place of business" would need to be made on the basis of the current 12 CFR §1263.18(c) alone. This would create havoc as all members and Banks would need to conduct a substantial reevaluation exercise and doubtless many transfers of membership would be required, to no discernable positive effect.

[18] 12 CFR §1263.18(b)
[19] 12 CFR §1263.18(c)
[20] 497 U.S. 358, 375 (1990)

O***ther Changes***

Other Changes not specifically addressed above generally are not necessary because they either represent conforming ancillary Changes that have no context or purpose once the primary Change is withdrawn, or they are of little value standing on their own. For example, the Proposal describes various "non-substantive revisions to provide greater clarity, with no change in meaning intended" [74] and elimination of "regulatory provisions [that] no longer have any relevance or effect" [75] or which have been rendered moot. [77] While we understand the appeal of a good Spring cleaning to keep regulations tidy, we would defer that to another Spring. Do not delay the prompt retraction of the objectionable Changes while the FHFA staff sifts through the non-substantive Changes to identify those that might remain desirable simply as a matter of hygiene.

One other Change does deserve special mention here. The definition of "Home mortgage loan" would be expanded to include other mortgage-backed securities in addition to pass-through securities. [30] We agree that all securitized interests in home mortgage loans should be considered "home mortgage loans." However, we do not believe that the definition needs to be expanded to accomplish that objective. The existing clause (1) of the definition begins "A loan, whether or not amortizing, *or an interest in such a loan*, which is secured by . . . a first lien on one of the following . . . ." (emphasis added) A proper understanding of the phrase "or an interest in such a loan" already should include interests represented both by pass-through and tranched mortgage-backed securities. No further expansion of the definition is required. This understanding could be communicated though the FHFA and the System by less formal means than a revision of the Current Rules. In a future rulemaking, clause (2) of the definition could be removed for added clarity, with that understanding of the phrase cited as the reason.

Withdrawal is necessary and time is of the essence

Certain phrasing of the Proposal has had a chilling effect on the pending Bank membership applications of SABRE and several other prospective members similarly situated. In particular, the misguided concerns about the safety and soundness of captive insurance company members [25:27] and the FHFA's stated view that current applicants could be subject to immediate expulsion if they were approved for membership before a final rule was adopted have frozen our application in its tracks. Therefore, it is vital that the Proposal be withdrawn rather than simply allowed to remain outstanding without the adoption of any final rule.

We believe that SABRE would have made a good Bank member last year, is a good candidate for Bank membership now and can be a good Bank member in the future. No useful purpose is served by further delaying the decision on this matter. However significant public harm accrues with each passing day that the System is denied access to the additional capital and capacity for housing finance investment which our membership would bring. SABRE also suffers by the prolonged exclusion from Bank membership for which it is qualified under any plain reading of the Bank Act. Therefore, it is critical that the Proposal be withdrawn at the earliest date possible.