January 12, 2015

Federal Housing Finance Agency
400 Seventh Street, SW
Washington, D.C. 20024
Attention: Alfred M. Pollard, General Counsel

Re: RIN 2590-AA 39, Proposed Rulemaking Regarding Membership Requirements in the Federal Home Loan Bank System

Dear Ladies and Gentlemen:

We appreciate the opportunity to comment on the Federal Housing Finance Agency ("FHFA") Notice of Proposed Rulemaking and Request for Comments—Members of Federal Home Loan Banks (RIN 2590-AA39)(referred to as the "Proposed Rule").[1]

Dynex Capital, Inc. ("Dynex") is an internally managed real estate investment trust, the common stock of which is listed on the New York Stock Exchange. Dynex does not currently have a captive insurance company subsidiary. As a mortgage REIT, Dynex is limiting its comments in this letter to those aspects of the Proposed Rule that would eliminate captive insurance companies from membership in the Federal Home Loan Bank ("FHLB") system.

Summary of Opinion

We believe that the Proposed Rule is fundamentally at odds with the broader national objectives of promoting and facilitating the development of a safe and sustainable housing finance system in the United States in which private capital is intended to play an important role. The timing of the Proposed Rule is particularly detrimental to bringing private capital to bear as the GSEs and Federal Reserve reduce their involvement in the mortgage market. The Proposed Rule would have a negative impact on the U.S. housing markets by limiting access to FHLB funding by long-term holders of housing related assets, such as mortgage REITs, which today serve as essential private capital vehicles injecting capital into the housing finance system. The Proposed Rule indirectly limits capital formation in, and allocation to, the housing markets as the benefits of funding diversification and membership in

[1] 79 Fed Reg 54848 (Sept 12, 2014), hereinafter the Proposed Rule.

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the FHLB would likely enable mortgage REITs to raise additional equity capital to invest in residential mortgage securities.

It is our understanding that there are no existing laws or regulations that prevent Dynex from becoming an FHLB member through a captive insurance subsidiary. Instead, we understand that the FHFA has issued the Proposed Rule principally due to its concern regarding its ability to adequately monitor the assets, borrowings and financial condition of captive insurance entities and related safety and soundness issues. We believe that mortgage REITs do not present a safety and soundness issue due to the regulatory oversight by the SEC (currently) and state insurance agencies (prospectively, if a mortgage REIT were to form a captive insurance subsidiary); FHLB risk management practices which to date have resulted in no losses to the FHLB system, the inherent safety mechanisms in a reverse repurchase transaction such as asset type, haircuts and margin requirements including significant excess collateral requirements.

We believe the activities contemplated within captive insurance subsidiaries are highly supportive of credit extension in housing and housing markets and very much aligned with the FHLB mission. Insurance company members of the FHLB use advances to fund new mortgage loan originations, purchase mortgage-backed securities, manage interest rate risk associated with their mortgage portfolios and otherwise fund their mortgage portfolios. Any captive insurance subsidiary created by Dynex would use advances in the same manner, in order to support credit extension and liquidity in housing.

In the past, Congress has had an opportunity at various junctures to circumscribe or redefine the mission of the FHLBs and, when considering the mission of the FHLBs, has done the opposite. Congress has repeatedly expanded FHLB membership and acknowledged the FHLB's role as a liquidity provider to long-term holders of mortgage related assets. Hence, the continued growth of the mortgage REIT industry at this critical juncture in American housing finance history should be supported. We believe that access by mortgage REITs to the FHLB system will result in an increase in the private capital committed to the U.S. housing system and will serve as a catalyst to a sustained recovery in housing with the FHLB serving a more prominent role in the evolution of our housing finance system over the next several years.

As we discuss below, the mission of the FHLB system has always been to support the country's housing finance system. Since 1932, when the FHLB system was created on the heels of another financial crisis, Congress has consistently expanded the FHLB's mission to reflect market realities and address the fact that the participants in the mortgage market had become more varied. Now, the FHLB's members include thrifts, insurance companies, commercial banks, credit unions and community development financial institutions. Like these entities, Dynex (along with other mortgage REITs) also plays an important role in the mortgage market. The Proposed Rule would eliminate potential access to FHLB financing and hence

limit our ability to increase the amount of capital we bring to the American homeowner or renter.

We respect the FHFA's concern for safety and soundness given the past history of financial crises that have originated within the housing finance system. We also agree that FHLB membership and subsequent loan advances should be handled within an overall disciplined structure of risk management and regulation. We believe the Federal Home Loan Banks have an excellent track record with respect to their loan advances to members. Furthermore, Dynex (and other mortgage REITs that are public companies) are subject to ongoing regulation and oversight. Public SEC filings should provide transparency for the FHLBs to form appropriate risk assessments prior to any extension of credit. We believe that between the inherent safety mechanisms in reverse repurchase agreements, risk and counterparty management of the FHLB, regulatory oversight by state insurance regulators and the SEC and REIT tax requirements, as well FHFA oversight, a fundamentally strong framework can be built that supports the membership of captive insurance REIT subsidiaries into the FHLB system.

Background on Dynex

Dynex, one of the oldest mortgage REITs in existence today, is uniquely and ideally positioned to be a strong counterparty and partner to the FHLB system in fulfilling its housing mission. We have a track record of raising and managing capital dedicated to housing finance for three decades and we are skilled risk managers of long-term mortgage related assets. As such, we believe our business has always been aligned with the FHLB mission. Over the last 27 years, our team of skilled risk managers has functioned in all aspects of housing finance. During the 1990s, Dynex originated and serviced loans on residential and multifamily properties in addition to purchasing a broad array of mortgage-related securities. At that time we obtained term financing via the non-Agency securitization markets and short-term financing through repurchase agreements and committed facilities with various commercial banking entities. It is important to note that Dynex was one of the earliest innovators in the non-Agency mortgage-backed securities market. A material percentage of our loans were extended to affordable properties through the LIHTC (Low Income Housing Tax Credit) program. We have maintained an outstanding reputation as a borrower, as we have always ensured our lenders were repaid in full.

Our business model has evolved such that today our investment strategy heavily favors shorter duration and higher credit quality securities. Our assets include both Agency and non-Agency mortgage-backed securities with over 90% backed by both residential and multi-family properties. We continue to support the housing markets with our private capital, particularly in times of distress. For example, Dynex was one of the earliest investors in the Freddie Mac K multifamily securities program when few other investors could be persuaded to take on risk in lower rated, non-guaranteed tranches. Over the past four years we have consistently

invested in both the government and non-government guaranteed securities issued by the Freddie Mac multifamily division.

During the first quarter of 2014, Dynex was invited by the Federal Home Loan Banks of Seattle, Indianapolis and Boston to consider applying for membership via a captive insurance subsidiary. Prior to these discussions, Dynex had not attempted to apply for membership in the FHLB system. Upon closer examination, we considered the respective Bank's efforts to expand their membership to be an excellent idea and fully in line with the public policy efforts in Washington DC to encourage private capital to play a larger role in housing finance. Although FHLB membership is unnecessary for Dynex to remain a very profitable company, it would allow us to play an even larger role in housing finance and provide us a more durable financing source that will, in aggregate, help reduce the overall riskiness of the housing finance system.

The US Housing Finance System and Mortgage REITs

The U.S. real estate finance system has yet to recover fully from the financial crisis and is in major need of change. In the aftermath of the financial destruction wrought by the collapse of the U.S. housing market and the subsequent freezing of credit markets, there exists a legacy of substantial governmental involvement in the U.S. housing finance system. In June 2014, the United States Department of the Treasury requested comment on the types of market practices and standards that would be necessary to support a private label securities market "...of significant scale and liquidity to improve the overall efficiency of the U.S. housing finance system."[2] Underlying this request for comment is the recognition that, six years after the financial crisis and despite a number of legislative proposals introduced in Congress to address the housing finance system, the mortgage market in the United States remains substantially reliant on government support. Currently, over 80% of mortgages originated in the United States are funded through a government-supported channel, either through GSEs or with FHFA insurance. Additionally, the Federal Reserve, through its Quantitative Easing program became a significant purchaser and the largest holder of Agency MBS. This level of government involvement is not ideal and housing finance reform has focused on measures that, if adopted, would serve to increase the influence of private capital.

Measures, such as those reflected in the Proposed Rule that, in essence, would make it more difficult to promote private capital participation in the mortgage market, are counter to fundamental public policy goals. If ensuring that Fannie Mae and Freddie Mac will no longer dominate the aggregation, pooling and securitization functions in the residential mortgage market of the future remains a national priority, some of their current functions need to be undertaken by other participants in the mortgage market.

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[2] U.S. Treasury Department Press Release, dated June 26, 2014 (available at http://www.treasury.gov/press-center/press-releases/Pages/jl2446.aspx).

Dynex, like other mortgage REITs, plays a significant role in the U.S. housing market because it is a vital source of private capital for the residential mortgage market and the commercial multifamily market. As important buyers of mortgage loans and mortgage-related securities, mortgage REITs act as a conduit for private demand for mortgages. As of the fourth quarter of 2013, mortgage REITs held almost as much outstanding Agency MBS as the GSEs, and they had combined assets of over $300 billion.

In the future, the balance sheets of private companies, such as mortgage REITs, will be needed to replace the historical role played by the government through the GSEs and the Federal Reserve. Historically, the GSEs have financed a substantial portion of the long-term fixed rate mortgages in the United States. As the GSEs' role diminishes, much of that financing requirement has been pushed to the private sector, which is fundamentally underpinned by short-term obligations. It is prudent and logical to be mindful of the broader efforts to encourage private capital participation in the mortgage markets before undertaking actions that would have a chilling effect on the activities of private mortgage capital sources.

FHLB Membership Impact on Dynex

FHLB membership and the associated stable, predictable financing would have an immediate positive impact on Dynex's ability to bring private capital to the mortgage market. We would be able to broaden our investment strategy at a crucial time for the housing market. We would be able to match our asset and liability maturities more effectively, improving our overall financial flexibility and strength. We would also reduce our reliance on the short-term repurchase agreement market and the Wall Street dealer community, reducing our exposure to systemic risk. By way of specific examples, access to the FHLB system would have the following impacts on Dynex:

1. *Expanded Investment Options, including affordable housing.* Predictable access to longer duration borrowings would allow us to expand our investment options to longer duration fixed rate mortgages and new mortgage related instruments such as GSE risk transfer securities (CAS and STACR) and single-family rental property securitizations (reducing the amount of non-performing assets and providing an affordable housing solution to families who want a single family home but cannot yet afford to purchase).

2. *Better Liability Management:* FHLB funding provides for a better and more effective matching of asset and liability durations (a more durable source of funding than repurchase agreement markets), which would improve our overall financial condition and, by extension, the financial condition of all participants in the housing finance market. For example, we estimate that if we diversified 25% of our borrowings by taking a fixed rate FHLB advance

for 7 to 10 years, it would lengthen the average maturity of our liabilities from six months to approximately three years.

3. *Reduced reliance on short-term debt.* We would seek to diversify our debt counterparties by borrowing from the FHLB system. This would reduce our reliance on Wall Street dealers/banks and more importantly on foreign banking institutions, which are governed by oversight bodies outside of our borders. This borrowing option to diversify our liability counterparties would reduce the risk in our balance sheet and, in aggregate, reduce the riskiness of the housing finance system. Furthermore, during times of market stress (such as in 1987, 1998, and 2008) the FHLB will be a more durable lending counterparty and hence reduce the risk of liquidity disruptions due to asset fire sales.

4. *Renewed ability to make loans to underserved communities.* We would seek to find ways to make loans again to underserved communities. As mentioned earlier, in the past, we have committed significant amounts of capital to loans originated through the Low Income Housing Tax Credit Program. Since 2008, the housing recovery has not evenly impacted all communities in the United States. Many of these types of loans are riskier but may prove profitable if the FHLB offered financing that is deemed more durable over the long-term.

The key to financing a broader array of assets is to have access to the broader array of financing options that are offered today through the FHLB system.

Insurance Company FHLB Members

FHLB members all use advances to fund new mortgage loan originations, purchase mortgage-related securities, manage interest rate risk associated with their mortgage portfolios and otherwise fund their mortgage portfolios. Any captive insurance subsidiary established by Dynex intends to use advances in the same manner, and should be treated as insurance companies have historically been treated in the FHLB system. This is wholly consistent with the FHLB's mission—members are provided with stable funding to provide credit and promote liquidity in the mortgage markets.

The FHFA's proposal to prohibit new and phase-out existing captive insurer membership in the FHLB system will inhibit the ability of Dynex and other mortgage REITs to funnel much needed private capital into the U.S. housing finance system. The Proposed Rule suggests that admission of captive insurers is somehow inconsistent with the FHLB's fundamental mission of providing lenders access to a reliable and stable source of liquidity and funding. In reality, the contemplated activities are entirely consistent with the mission and intent behind the creation of FHLB system.

FHFA/FHLBs and Risk Management

We acknowledge the FHFA's concern regarding adequate surveillance of captive insurance subsidiaries. We agree that without appropriate limitations and controls the FHLB system could facilitate a misallocation of capital to housing related assets similar to that which occurred during the prior decade. We support the need for rigorous risk management and appropriate controls.

We believe the FHLBs currently have the ability to manage the risks associated with extending advances to Dynex and other mortgage REITs. More important, the current structure of FHLB membership (including allowing membership to captive insurance subsidiaries of mortgage REITs) and loan advances is fully aligned with the underlying premise of the Dodd-Frank Act that require "risk retention" and "skin in the game." In fact, the FHLBs currently have the best process for ensuring long-term holders of mortgage related assets are fully aligned with the performance of those assets over time. For example, in order for Dynex to borrow from the FHLB system using Agency MBS as collateral, we would have to over-collateralize by approximately 10% of the notional balance of the funding as a result of collateral margin and activity-based stock purchase requirements. This is twice the requirement of the reverse repurchase agreement market. Given the excess capital posted at the FHLB, we would be active shareholders in the FHLB system to ensure that appropriate risk procedures are in place to protect our capital investment.

Nevertheless, in order to minimize the risk to the FHLB System, we would propose the following for the FHFA to consider:

1. *Membership limited to entities with housing nexus.* Membership of captive insurers should have some limitations and be prioritized appropriately. Companies dedicated to the housing finance system that are long-term holders of mortgage related loans or securities should be given priority. The parent companies of any FHLB member should have 50% or more of their assets continually invested in mortgage related assets backed by residential and multifamily properties.

2. *Membership limited to regulated entities.* The FHFA/FHLBs should take comfort in the current regulations in place that guide public mortgage-REIT behavior and disclosures. Existing tax and Investment Company Act limitations specifically limit the operations and permissible investments of mortgage REITs. In order for a mortgage REIT to maintain its favorable tax status and its exemption from registration under the Investment Company Act, it must monitor on a quarterly basis the scope of its activities and assets. The mortgage REITs that have captive insurance company subsidiaries that are FHLB members are public companies, subject to SEC reporting requirements, as well as to corporate governance requirements imposed by the SEC and by the national securities exchange on which their stocks are listed or quoted. The FHFA notes in its release regarding the Proposed Rule,

with respect to mortgage REITs, that the FHLBs "do not currently have access to the kind of detailed financial and supervisory information that is readily available to them in the case of institutions that are eligible for [FHLB] membership." We believe that the SEC filings of public mortgage REITs provide detailed information. Furthermore, as a lender, the FHLBs will have the right to request any additional information that is needed to help analyze a potential new member or new transaction.

3. *FHLB Risk Management Practices.* FHFA should ensure that all banking districts have in place appropriate personnel and processes to assess the risks of a membership base that includes mortgage REITs. Our experience based on meetings with individual FHLB Banks is that they have sophisticated personnel and risk management infrastructure capable of managing risk associated with mortgage REIT captive insurance companies.

4. *FHLB Mission.* The FHLBs should adhere to their mission. According to the FHFA website, "The Federal Home Loan Bank System was created by the Federal Home Loan Bank Act as a government sponsored enterprise to support mortgage lending and related community investment." Appropriate risk controls and regulations should be in place to prevent access to the FHLB from entities that are not aligned with this mission. The current proposed rule, however, is too restrictive and eliminates potential members that are closely aligned to the mission.

It is important to note that the Federal Reserve continues to seek ways to reduce the risks associated with the short-term repurchase agreement market. Allowing mortgage REITs to borrow through the FHLB system will serve to reduce the risk of the overall leverage in the housing finance system.

Conclusion

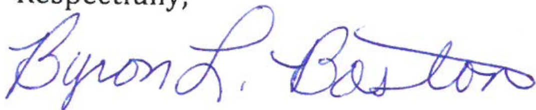
For the past three decades Dynex has committed the substantial majority of its capital to the longer-term investment in FHLB mission related assets. In the aftermath of the financial crisis, it has become apparent that regulations implemented pursuant to the Dodd-Frank Act, including those regulations implementing the Basel III framework, have, when taken as a whole, served to limit the ability of banks to originate certain types of mortgage loans and to hold mortgage loans and certain mortgage related assets on their balance sheets. Private capital has become more important than ever as a result of these developments, and we believe that this is well understood by other government agencies. It is prudent and logical to be mindful of the broader efforts to encourage private capital participation in the mortgage markets before undertaking actions that would have a chilling effect on the activities of private mortgage capital sources, like Dynex Capital and other mortgage REITs.

We believe that the FHFA Proposed Rule is fundamentally at odds with the broader national objectives of promoting and facilitating the development of a safe and sustainable housing finance system in the United States in which private capital is intended to play an important role.

As discussed above, we believe that the inherent safety mechanisms in the reverse repurchase agreement, risk and counterparty management of the FHLB, regulatory oversight by state insurance regulators, the SEC and IRS as well the FHFA, together a fundamentally strong framework can be built that supports the membership of captive insurance REIT subsidiaries into the FHLB system.

We believe that membership in the FHLB system for Dynex Capital and entities like Dynex Capital will be a tremendous positive, contributing to a sustained recovery in housing and effectuating the transition from government support to a vibrant private capital market. The FHLB system by virtue of its ability to access longer-term low cost financing will provide a mechanism for its members to supplant the role of the GSEs. We recommend that the FHFA align its policies with the public policy desires of our country by encouraging more private entities such as Dynex Capital and mortgage REITs to assume more of the risk inherent in our housing finance system. Over the long term, we believe this will reduce the likelihood of another financial crisis.

Respectfully,



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