



July 24, 2015

VIA EMAIL

Fred C. Graham
Deputy Director
Division of FHLBank Regulation
Federal Housing Finance Agency
Constitution Center
400 7th Street
Washington, DC 20024

Dear Fred:

The Bank Presidents' Conference (BPC) of the Federal Home Loan Banks (FHLBanks) established a working group of FHLBank Presidents and staff to evaluate options for defining the parameters of captive insurance company membership and lending within the FHLBank System (System). Through this project, the FHLBanks have evaluated their collective activities and experience related to captive insurance company lending, and propose a set of general principles that will guide each of the FHLBanks that chooses to participate in this area. The general principles include a commitment to ensuring that all captive members, their parent or affiliated entities, collectively, have a documented and demonstrated nexus to the FHLBanks' housing and community lending mission, and that all advances to captive members are underwritten and collateralized in accordance with appropriate standards of safety and soundness.

To implement these guiding principles, the BPC has approved the following framework for future captive insurance company membership and lending by the FHLBanks. The framework is based on the guiding principles above: ensuring an appropriate nexus between the mission of the FHLBanks and the captive insurance members, their sponsoring parents or affiliated companies, and leveraging the current, existing best practices among the FHLBanks in lending to captive insurance companies to maintain the safety and soundness of the System. This framework has been reviewed with legal counsel to ensure that it complies with the FHLBank Act (Act) and the implementing regulations of the Federal Housing Finance Agency (FHFA). See Appendix A: Legal Analysis Supporting BPC Membership Framework. The Federal Home Loan Bank of Atlanta (FHLBank Atlanta), together with the other FHLBanks, believes that through the voluntary agreement of the FHLBanks under this framework to ensure a continued nexus between captive insurance companies, their parents or affiliates, and the mission of the FHLBanks and to work together to ensure appropriate standards of safety and soundness are met in lending to these institutions, the FHLBanks are acting consistently with their statutory purposes. This action also is consistent with the discretion permitted to the FHLBanks and the FHFA to limit membership and lending to institutions that meet mission and safety and soundness-related conditions.

Finally, FHLBank Atlanta, together with the other FHLBanks, believes that continuing to permit captive insurance companies to access the FHLBanks is important to support the evolving housing finance market and fulfill the FHLBanks' mission. See Appendix B: The Evolving Housing Finance Market. Real estate investment trusts (REITs), particularly those investing in mortgage assets (Mortgage REITs, or MREITs), which in some cases are sponsors of captive insurance companies that borrow from the FHLBanks, are increasingly important participants in the mortgage market. Permitting continued access to captives sponsored by REITs, including MREITs, and other housing-related entities, would assist in fulfilling the statutory mandate of the FHLBanks and supporting the expansion of housing opportunity and liquidity in the United States.

Executive Summary of Framework

The FHLBanks have adopted the following voluntary framework for captive insurance company membership and lending within the System:

- (1) To be eligible for membership in an FHLBank, the captive member and its sponsoring parent, together with their affiliated entities as appropriate, collectively, should have a documented and demonstrated nexus between their policies and activities and the housing and community lending mission of the FHLBanks; and
- (2) The FHLBanks will continue to share and enhance requirements for lending to insurance company members, including captives, and will commit to establish safe and sound lending practices to captives.

The nexus requirement in item (1) above could be met by captive insurance companies, their sponsoring parents or affiliates, based on a number of factors which will be established and documented by each FHLBank participating in this activity, including (A) a specified percentage of housing-related assets held by the captive, parent or affiliates; (B) engagement in a range of housing-related activities that support liquidity and affordability in the housing finance market; or (C) having other measurable demonstration of a principal business line related to housing or community lending. When establishing these factors the FHLBanks will give consideration to ensuring that entities not engaged in sufficient mission related activities will not have access to the funding provided by the FHLBank.

The FHLBanks already have a demonstrated history of working together to share enhanced lending practices and implementing these practices to ensure safe and sound operations, particularly in the area of insurance company lending. Building off of this experience and the experience of those FHLBanks currently lending to captive insurance companies, this framework would require continued collaboration in this area. In particular, to implement item (2) in the framework above, subject to any applicable law or policy with respect to sharing business practices, the FHLBanks would share information about their experiences in the following areas and will commit to establish safe and sound lending practices to captive insurance companies:

- (1) Evaluation of the operations and supervision of the captive member and its parent;
- (2) Evaluation and mitigation of legal risks related to captive members and their parent entities;

- (3) Creation of appropriate legal documentation for safe and sound lending to these entities;
- (4) Appropriate collateral management policies;
- (5) Appropriate credit evaluation and monitoring of captives and their parents;
- (6) Maintaining open lines of communications with insurance regulators and other regulatory entities overseeing captives and their parents; and
- (7) Retaining the necessary expertise to ensure safe and sound lending practices.

Membership and Lending Framework

1. Require Captives, Parents and Affiliates to Have Demonstrated Nexus to FHLBank Mission

Currently, to be eligible for membership under 12 CFR § 1263.6, an insurance company must:

- (i) be duly organized under the laws of a state as an insurance company;
- (ii) be subject to inspection and regulation under the banking laws, or similar laws, of a state;
- (iii) make long-term home mortgage loans;
- (iv) be in such financial condition that advances may be safely made to it;
- (v) have management with the character consistent with sound and economical home financing;
- (vi) have a home financing policy consistent with sound and economical home financing; and
- (vii) have mortgage-related assets that reflect a commitment to housing finance.

These conditions help ensure that captive insurance companies, like other FHLBank members, possess the necessary safety and soundness and nexus to the mission of the FHLBanks. For example, captive insurance companies, like other insurance company members, must be established in compliance with state insurance laws, organized as an insurance company under those state laws, and appropriately regulated and supervised by state insurance regulators. These regulators have oversight authority over these entities, including business plans, financial condition and governance.

In the case of captive insurance companies, however, they may be established by a wide variety of entities, and their ownership structure and organization could permit institutions unrelated to the mission of the FHLBanks to access benefits of membership contrary to desirable public policy in this area. For that reason, the FHLBanks believe that additional provisions and safeguards are necessary to ensure that both the captive insurance companies and their sponsoring parents or affiliates, taken together, are aligned with the mission of the System.

Under this framework, each FHLBank has agreed, prior to admitting any new captive insurance company member, that it will ensure that the captive member and its sponsoring parent, together with their affiliated entities as appropriate, collectively, have a documented

and demonstrated nexus between their policies and activities, and the housing and community lending mission of the FHLBanks. This nexus requirement could be met by the captive insurance companies, their sponsoring parents or affiliates, based on a number of factors, which will be established and documented by each FHLBank participating in this activity, but could include one or more of the following representative activities:

- Holding a specified minimum percentage of housing-related assets by the captives, parents or affiliates, which may be required to be met on a continuing basis in order to maintain access to advances;
- Engaging in a range of housing-related or community lending activities that support liquidity and affordability in the housing finance market; or
- Having a principal line of business related to housing or community lending, such as a mortgage REIT or other entity focused on housing or community lending.

2. Continue to Adhere to Rigorous Safety and Soundness Conditions for Captive Lending and Commit to Specific Risk Management Practices Among FHLBanks

Several FHLBanks have operated safe and sound lending programs for captive insurance companies for several years, and that experience can be leveraged to ensure that this lending program remains consistent with appropriate standards of safety and soundness. In many cases, these lending programs include substantial requirements imposed on the sponsoring parent of the captive insurance company to ensure the safety and soundness of the lending programs from the FHLBanks' perspective.

The FHLBanks will continue to collaborate and share risk management practices in this area and have committed to the following Risk Management Practices on Captive Lending:

- Review of regular financial statements, including annual financial statements, from the captives (audited, if available) and their sponsoring parent (audited required).
- Review of copies of submissions to the state departments of insurance, including the captive insurers' business plans, if available.
- Evaluation of the legal structures of captive insurance companies and their affiliates to assess any implications they may have on secured borrowing transactions.
- Assessment of the regulatory structure of the captive insurance companies' jurisdictions of organization and evaluation of their legal authority to:
 - Purchase FHLBank stock
 - Encumber assets; and
 - Borrow funds.
- Assessment of the structure of FHLBank advances and collateral agreements (including affiliate pledge agreements) with captive insurance members and their affiliates, and the protection of secured claims, including:
 - Perfection of the FHLBank's security interest in pledged collateral;
 - Superiority of secured creditors' rights versus other creditors (secured or unsecured);

- Evaluation of superiority of secured claims versus the rights of a receiver or bankruptcy trustee; and
- The authority of the captive insurance company to use a funding agreement, if available, and to pledge collateral under the funding agreement, and whether the FHLBank would be recognized as a secured creditor and able to obtain a first-priority perfected security interest in pledged collateral.
- Evaluation and assessment of the applicability of state insolvency regimes and federal bankruptcy, including:
 - Assessment of insurance receivership laws and impact on secured creditors rights;
 - Evaluation and assessment of the impact of a bankruptcy by a captive insurance company's parent or affiliates; and
 - Evaluation and assessment of the risk of a consolidation of assets in the event of a bankruptcy.
- Adherence to rigorous collateral management practices, including:
 - Uniform Commercial Code (UCC) searches and filings, as appropriate;
 - Special provisions that may apply to captives based on any unique legal and structural risks they pose:
 - Holding period considerations for establishing collateral haircuts
 - The assets and investments held by captive insurance companies and its sponsoring parent, if applicable
 - Establishing and maintaining appropriate haircuts
 - Additional legal agreements as needed;
 - Determining appropriate collateral valuations, including periodic updates;
 - Collateral verifications of whole loan collateral;
 - Collateral liquidation testing and simulation under event of default scenarios; and
 - For captive insurers of non-depositories, require possession or control of collateral, either directly or through a tri-party collateral or control agreement.
- Adherence to rigorous credit management standards, including:
 - Ensuring the captive member and/or guarantors have sufficient capital;
 - Regular evaluation and assessment of the capital levels of the captive;
 - Assessment of parental strength, such as:
 - Capitalization
 - Other funding sources available
 - Amount of leverage used
 - Ability to infuse capital into captive
 - Risks of other secured creditors
 - Other data as available;
 - Evaluation of the captive insurance company's insurance activity, types of risks insured and other business activities;
 - Establishment of appropriate credit limits; borrowing capacity is based on the captive insurer's assets unless there is an agreement with an affiliated entity acceptable to the FHLBank, in which case consideration may be given to affiliated relationships; and

- Understanding of captive insurance company regulatory reporting requirements and supplemental reporting requirements, if necessary, including:
 - Quarterly financial submissions
 - Parent and affiliate company filings, including non-public information (as appropriate)
 - Annual audited filings
 - Other regulatory filings, including but not limited to, actuarial opinions and business plan changes.
- The FHLBank communicates with the domiciliary state insurance regulator of the captive insurance company to establish an understanding of the benefits and costs associated with FHLBank membership as well as to understand the regulator's views on the utilization of FHLBank membership, advances and other credit, the pledging of collateral, and expectations of access to collateral by the FHLBank in the event of a liquidation or rehabilitation of the captive insurance company.
- The FHLBank utilizes appropriate internal and external resources and expertise to ensure a rigorous analysis of all relevant aspects of lending to the captive insurance company.

3. Request for a Determination on Principal Place of Business for Captives

One area in which FHLBank Atlanta feels that additional regulatory guidance would be helpful would be in the area of determining the principal place of business (PPOB) of captive insurance companies. Given the unique nature of captive insurance companies, which may be formed relatively quickly and inexpensively in multiple states, we believe that the FHFA should adopt a clear rule for determining the appropriate PPOB for a captive insurance company. Such a rule may include the standards proposed in the FHFA's Notice of Proposed Rulemaking on Members of the FHLBanks, issued on September 2, 2014.¹ The proposed rule included a reference to situations in which the member/applicant maintains no physical offices of its own and has no employees of its own, which may occur if a company contracts out the actual operations of the insurance business to an affiliate or third party, which may often be the case for a captive. In those circumstances, the proposed rule would designate the state of domicile as the PPOB, which also has the advantage of aligning the FHLBank district for membership with the state of regulatory oversight of the captive, particularly in case of an insolvency.

Whatever test for PPOB is determined by the FHFA, we also believe that the FHFA should prohibit multiple memberships utilizing one or more captives within a single family of affiliated companies in more than one FHLBank district. Otherwise, we believe that this may undermine the regional structure of the FHLBanks established by Congress in 1932, and may lead to competition among the FHLBanks that is harmful to the safety and soundness of the System and the joint and several liability of the FHLBanks.

¹ FHLBank Atlanta provided comments on this portion of the proposed rule in a letter submitted to FHFA on January 12, 2015. We continue to believe the enhancements to the proposed rule outlined in that comment letter would be useful in determining the PPOB for captive insurance companies also.

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Conclusion

This framework will be adhered to by FHLBank Atlanta and the other FHLBanks, subject to any additional guidance from the FHFA impacting captive insurance company membership or lending, whether in the form of supervisory feedback, or issuance of an advisory bulletin or final rule.

Sincerely,



W. Wesley McMullan
President and Chief Executive Officer

Appendix A

Legal Analysis Supporting BPC Membership Framework

The FHLBanks believe that the membership and lending framework proposed above satisfies all necessary legal requirements related to FHLBank membership as described below. While the FHLBank Act provides for all regulated insurance companies to apply for membership, it is consistent with the Act for FHLBanks to consider distinctive characteristics of captive insurance companies when exercising their discretion to approve or deny applications for membership. These considerations along the lines of the framework outlined above could be instituted through joint agreement among the FHLBanks (overseen by the FHFA), an advisory bulletin and examination guidance, or a final rule. Whatever form is used to implement this framework, it should provide for the necessary flexibility for an evolving housing finance market, upcoming legislative initiatives, and the necessary flexibility in application to allow the FHLBanks to fulfill their statutory purposes.

1. All Captive Insurance Companies Are Eligible to Join an FHLB

Insurance companies have been eligible to be members in the FHLBanks since the original FHLBank Act was enacted in 1932. The Act states that "[a]ny building and loan association, savings and loan association, cooperative bank, homestead association, *insurance company*, savings bank, community development financial institution, or any insured depository institution . . . , shall be eligible to become a member of a Federal Home Loan Bank." While the Act does not define "insurance company", previous Federal Housing Finance Board guidance indicated that "insurance company" meant companies that engaged in underwriting insurance risk.² Captive insurance companies are formed to underwrite risks of both affiliated and unaffiliated entities. Thus, captive insurance companies are "insurance companies."

Captive insurance companies are licensed and comprehensively regulated by their state of domicile where formed by the same agencies as other insurance companies. Over thirty-five states and territories have laws that expressly govern captive insurance companies and under these laws, captive insurance companies are generally subject to the same terms and conditions pertaining to administrative supervision, conservation, rehabilitation, receivership, and liquidation as other insurance companies. Similar to other insurance companies, the ability of captive insurance companies to either lend money or pay dividends to affiliated organizations is tightly regulated and generally requires prior review and written approval from the applicable state insurance commissioner.³ Moreover, state courts have held that captive insurance

² FHFB, Op. Gen. Counsel, 1998-GC-12, at 1 (Sept. 18, 1998), *available at*

<http://www.fhfa.gov/SupervisionRegulation/LegalDocuments/Documents/FHFB-General-Counsel-Opinions/1998/1998-GC-12.pdf> [sic].

³ *See, e.g.*, Comments of the Delaware Department of Insurance, RIN 2590-AA39 3-4 (Apr. 1, 2011); Comments of the Vermont Department of Banking, Insurance, Securities' and Health Care Administration, RIN 2590-AA39 2 (Feb. 23, 2011); Comments of the Captive Insurance Company Association, RIN 2590-AA39, 1-2 (Mar. 27, 2011); *see also* NAIC, *Captive Insurance Companies* (last updated June 17, 2015), http://www.naic.org/cipr_topics/topic_captives.htm ("Once established the captive operates like any commercial insurance company and are subject to state regulatory requirements including reporting, capital and reserve requirements."); NAIC White Paper, *supra note* 83 at 52 app. B ("Current U.S. laws and regulations provide for ongoing monitoring of the ceding insurer, the captive, and the holding company.").

companies are "insurance companies" and engage in the "business of insurance."⁴

Like other insurance companies, captive insurance companies determine the risks to be underwritten, set the premium rates based on market conditions, write policies for the risks insured, collect premiums, and pay out claims for insured losses.⁵ Captive insurance companies also have reserves, surplus, policies, policyholders, and claims.⁶ Captive insurance companies are primarily formed to provide customized, flexible, efficient, and economical risk transfer solutions versus what is commercially available. As such, captive insurance companies increase economic efficiency and activity. The majority of captive insurance companies provide mainstream property/casualty insurance coverage, including general liability, product liability, workers' compensation, director and officer liability, auto liability, and professional liability. However, captive insurance companies can and do also underwrite credit risk, pollution liability, equipment maintenance warranty, and employee benefit risks (including medical benefits), personal accident, and whole life insurance.

While captive insurance company business models are diverse, only those with a legally-supportable nexus to housing markets, as required by current regulations, are approved for membership. Advances to captive insurance companies are only supported by eligible collateral. Captive insurance companies are subject to robust FHLBank credit requirements, similar to other FHLBank members, which requirements provide incentives to expand commitment to housing finance and community and economic development. Thus, captive insurance companies are "insurance companies" and, subject to satisfying the membership eligibility requirements, should continue to be able to apply for FHLBank membership.

2. FHLBanks and FHFA Have Discretion in Approving Captives for Membership

Each FHLBank is granted the authority to approve or deny all applications for membership, subject to FHFA requirements.⁷ Several of the membership requirements grant the FHLBank discretion in determining whether the information submitted by an applicant satisfies the particular membership requirement, including the commitment to housing finance for non-depositories in 12 CFR § 1263.6(c), the "makes long-term home mortgage loans" requirement in 12 CFR §1263.9, and the rebuttable presumptions in 12 CFR §1263.17. The discretionary standard of these requirements allow the FHLBanks to establish standards or thresholds when reviewing a prospective captive insurance company's information, thus providing some consistency when reviewing captive insurance companies' applications.

This discretion is also consistent with the transfer of the approval of membership applications from the predecessor agency of the FHFA to the FHLBanks.⁸ This transfer reflects the desire of that

⁴ See, e.g., *Lemos v. Electrolux N Am., Inc.*, 937 N.E.2d 984 (Mass. App. Ct. 2010) (holding that a captive insurer was in the business of insurance and therefore subject to the claims settlement practices act); *Wendy's Int'l, Inc. v. Hamer*, 996 N.E.2d 1250 (Ill.App. Ct. Oct. 7, 2013) (finding that a captive insurance company qualified as an insurance company because it engaged primarily in insurance activities and was a *bona fide* insurance company under income tax law).

⁵ See *supra* note 2.

⁶ See *id.*

⁷ See 12 CFR §1263.3(a).

⁸ See *id.*

agency to empower each FHLBank to make membership decisions so long as they are consistent with the FHLBank Act and implementing regulations. By adopting additional mission nexus requirements for captive insurance companies and their sponsoring parents that are aligned with the Act and regulations, the FHLBanks would be acting consistently with their statutory purposes and helping to ensure that membership is limited to those entities intended by Congress.

Appendix B

The Evolving Housing Finance Market

Mortgage REITs and Sponsored Captives Support the Mission of Federal Home Loan Banks

The core business activity of many of the sponsors of captive insurance company members, including real estate investment trusts (REITs), particularly REITs that invest in mortgage assets (MREITs or mortgage REITs) is consistent with, and furthers, the mission of the FHLBanks. The FHLBanks' core mission is to "serve as a reliable source of liquidity for their member institutions in support of housing finance and community lending."⁹ The core business activity of MREITs is consistent with this mission because MREITs have a deep mortgage focus; MREITs are one of the largest suppliers of liquidity for residential lending; and MREITs' role in housing finance is diversifying and deepening.

In order to qualify as a REIT, a company must have the bulk of its assets and income connected to real estate investment. For example, a REIT must (i) invest at least 75% of its total assets in real estate assets and cash; and (ii) derive at least 75% of its gross income from real estate related sources.¹⁰ This means, by definition, REITs have a singular focus on real estate, including mortgages.

Consistent with statutory requirements, MREIT balance sheets are heavily focused on residential mortgage assets (See Table 1). Agency mortgage-backed securities represent the single largest asset class in MREIT portfolios in the aggregate. For the past three years, 46% of total MREIT assets have been in agency mortgage-backed securities (MBS). Mortgages – single family and multi-family - represent another important asset class in MREIT portfolios. For the past three years, these mortgage loans represented another 4% of total MREIT assets. Over a half of MREIT balance sheets are connected directly to residential housing. For the past three years, agency MBS, home and multifamily mortgages have represented 51% of total assets. MREITs would easily satisfy the "makes" test component of FHLBank membership and, in fact, far exceed the required thresholds.

MREITs are one of the largest suppliers of liquidity in the residential mortgage market. And this liquidity support has grown in recent years at an important time in the residential mortgage markets. The contribution of MREITs to residential housing is evident by an increase in holdings of agency MBS, which reflected continuation of a long-term trend (See Chart 1).

In contrast, the total assets of U.S.-chartered banks grew by only 19% over the same period from \$11.5 trillion to \$13.6 trillion. This means that even though the banking sector is much larger (nearly twenty times larger) than MREITs in terms of levels of assets, MREITs account for an increasing share of flows in residential mortgage assets. This in turn means that MREITs are a very important source of liquidity for new residential mortgage assets being originated.

In 2014, MREITs increased holdings of home mortgages (1-4 family mortgages) by more than any other sector with the exception of credit unions (See Chart 2). In 2014, due to an improving but still

⁹ FHFA Strategic Plan: Fiscal Years 2015-2019, p. 10.

¹⁰ <http://www.sec.gov/answers/reits.htm>.

weak housing market overall across the nation, many sectors kept their home mortgage portfolios flat or reduced their holdings. However, MREITs increased their holdings of home mortgages by \$13 billion. Setting aside agency-backed mortgage pools, MREITs' increase in home mortgage holdings was exceeded only by credit unions. MREITs' increase in home mortgage holdings in 2014 exceeded the sum of increases in home mortgage holdings of all U.S. and foreign banks combined. MREITs increased their holdings of home mortgages by more than U.S.-chartered banks and insurance companies, both of which are eligible for FHLBank membership.

MREITs' role in the residential mortgage market is diversifying and deepening. MREITs are a critical source of private capital for the residential mortgage market, including in products not served by Fannie Mae and Freddie Mac (government sponsored enterprises, or GSEs). Redwood Trust was the first issuer of private label MBS following the collapse of that market during the financial crisis. Redwood Trust continues to issue residential MBS (RMBS) with underlying pools of loans that exceed the GSE conforming limit, providing much needed liquidity.¹¹ Some MREITs are building capabilities to provide funding for non-qualified mortgage (QM) loans. Originations for non-QM loans remain especially limited as lenders tread cautiously due to associated legal risks.¹²

Admitting MREIT captives into membership creates positive externalities for FHLBanks and their members. MREIT captives allow FHLBanks to grow and diversify their membership. A more diversified member base results in a stronger and more stable capital position. MREITs may opt for advances with longer maturities, which would bolster the stability of the FHLBanks' balance sheet. As the traditional depository industry continues to consolidate, MREIT captives represent an important source for growing and strengthening the FHLBank franchise value.

A substantial portion of MREIT assets are related to residential mortgages and a great majority of such assets are agency MBS, which are free from credit risk and could be pledged to secure advances. Income generated from advances made to MREIT captives also will result in an increase in funding available for affordable housing programs, directly benefiting local communities.

¹¹ Morrison and Foerster, "Mortgage REITS Poised to Benefit from Role in Emerging Housing Finance Market," May 2011.

¹² Jody Shenn, "Pine River's Two Harbors Now Targets Non-Prime Mortgages," Bloomberg.com, November 5, 2014.

Table 1: REITS Balance Sheet Composition

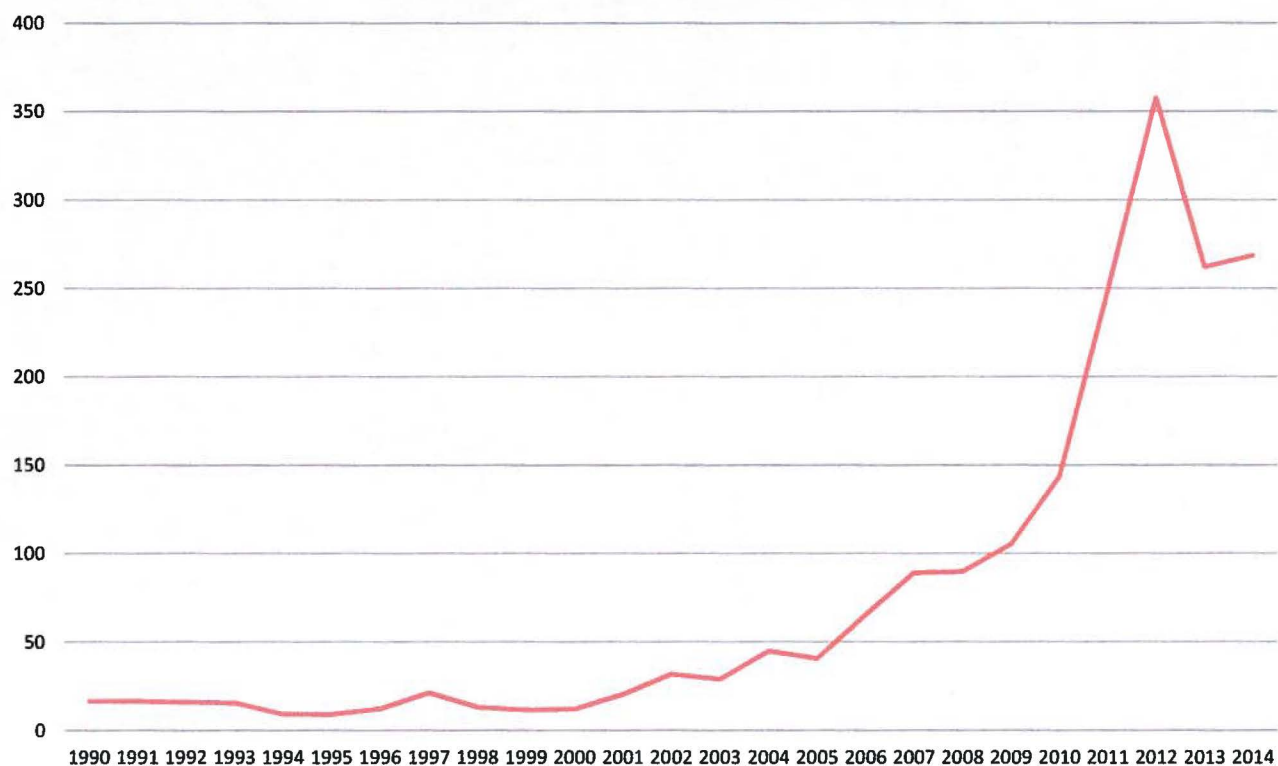
(\$ billions; amount outstanding at year end)

	2012		2013		2014		2012-2014
	Amount	% Total	Amount	% Total	Amount	% Total	Average % Total
Total assets	\$594		\$644		\$706		
Agency MBS	\$358	60%	\$262	41%	\$268	38%	46%
Mortgages	\$65	11%	\$199	31%	\$227	32%	25%
Home	\$27	4%	\$23	4%	\$36	5%	4%
Multifamily	\$2	0%	\$2	0%	\$4	1%	0%
Commercial	\$36	6%	\$174	27%	\$187	27%	20%
Agency MBS and Mortgages	\$422	71%	\$461	72%	\$496	70%	71%

Source: Financial Accounts of the United States, Q4 2014, Table L.128

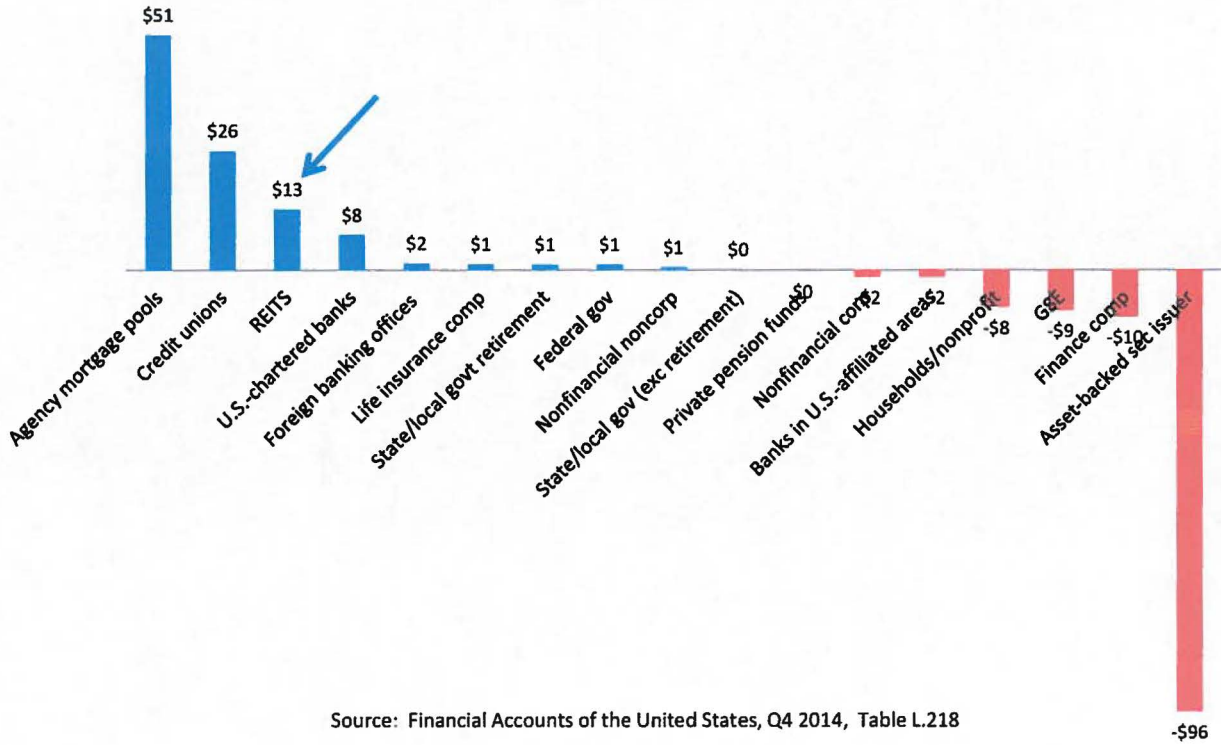
Chart 1: Agency MBS Holdings of REITs

(\$billions; amount outstanding at year-end)



Source: Financial Accounts of the United States, Q4 2014, Table L.210

**Chart 2: Changes in Home Mortgages Held in Portfolio by Sector
2013YE to 2014YE**
(\$ billions)



Source: Financial Accounts of the United States, Q4 2014, Table L.218