



July 24, 2015

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 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.

The FHLBank of Boston ("Boston" or "Boston FHLBank") supports these general principles, as well as the framework described in Section I of this letter, below, and commits to follow it with respect to any captive insurance companies that may join the Boston FHLBank. ***However, for the reasons set forth in Section II below (and as we proposed in our comment letter submitted to Alfred Pollard on January 9, 2015), Boston's support for the framework, and for captive membership more generally, is contingent upon a determination by the FHFA that the principal place of business of a captive insurer be based upon the physical location of the captive's sponsor. We strongly believe that captive membership under a "domicile" principal place of business standard puts the regional and cooperative nature of the FHLBank System at risk, and we urge the FHFA to impose a moratorium on new captive memberships until this issue is appropriately resolved, as described in Section III below.***

I. BPC CAPTIVE FRAMEWORK

A. Introduction

To implement the guiding principles agreed upon by the BPC, 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 described in the opening paragraph of this letter: 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 BPC 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.

The BPC 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.

B. Executive Summary of Framework

The FHLBanks, through the BPC, 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.¹ 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.

C. 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;

¹ As described more fully in Section II below, the FHLBank of Boston believes that this commitment to collaborate and share information is unsustainable if FHLBanks are directly competing for captive insurers' business due to the flexible and easily manipulated domicile-based principal place of business standard.

- (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 agrees, 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;
 - 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.

II. PRINCIPAL PLACE OF BUSINESS (“PPOB”)

The FHLBank of Boston believes that captive insurers have the potential to help the FHLBanks fulfill their housing finance mission and to contribute in a positive way to the financial strength of the FHLBank System. However, we also believe that permitting captive insurance companies to join FHLBanks based upon their state of domicile (rather than based upon the physical and substantive location of the sponsoring entity) poses a profound threat to the regional and cooperative nature of the Federal Home Loan Bank System. *For that reason, our support for the BPC framework set forth above, and for captive membership generally, is contingent upon the satisfactory resolution of this issue by the FHFA. As set forth in Section III below, we also urge the FHFA to institute a moratorium on new captive members until this issue is resolved.*

Traditional insurance companies generally select their state of domicile based upon their own business requirements, such as their service of customers in that state, or the impact of state laws on their operations. Moreover, organizing and licensing a new traditional insurance company is a relatively significant regulatory undertaking. As a result, and in light of the importance of state of domicile to the rights of secured parties, we support the inclusion of “domicile” in the analysis of principal place of business for traditional insurance companies.

On the other hand, captive insurers that primarily write insurance for their parent organizations are able to be entirely flexible in their choice of domicile. The cost and time involved in organizing a captive insurer is significantly lower than for a traditional insurance company or insured depository, providing the lowest barrier to entry for Federal Home Loan Bank membership in any of the 11 Federal Home Loan Bank districts that the sponsoring parent may choose. This ease of organization means that captive insurance companies may be (and we believe are being) organized, or redomesticated, in particular states primarily for the purpose of joining the Federal Home Loan Bank whose district includes those states, rather than for their own independent business reasons. Equally, or maybe even more, troublesome, an existing FHLBank member (whether an insured depository or traditional insurance company) could easily organize a captive insurance subsidiary domiciled in the district of a different FHLBank (or even in multiple FHLBank districts), in order to access what it perceives to be more attractive policies with respect to collateral, pricing, stock requirements or dividends.² This has the potential to fundamentally alter the current regional, cooperative nature of the Federal Home Loan Bank System, in a manner that deeply concerns us.

This is not just a theoretical concern. We are aware of captives (or their sponsoring parents, in this case REITs) collecting information about the collateral, advances pricing, stock investment and dividend practices of all 11 Federal Home Loan Banks before deciding where to domicile (and therefore which FHLBank to join). We have also heard of at least one insured depository member of an FHLBank discussing potential membership with a different FHLBank via formation of a captive subsidiary. We believe that this has the potential to commoditize

² An FHLBank in a declining financial condition could be further weakened if its members perceived that they could diversify their risk by migrating all or a portion of their advances business to another FHLBank by forming a captive insurance subsidiary in another district.

FHLBank products, likely at lower pricing and with reduced capital and collateral protections than many FHLBanks currently employ, leading to higher risk, reduced profitability and elimination of regional differences in how FHLBanks operate. The regionalization of our programs and management is viewed favorably by the investors in FHLBank debt, is considered a positive by our existing members, and is highly valued by the constituents of our Affordable Housing Programs. We believe that the commoditization of our offerings and the loss of our regionalized membership could call into question the need for multiple separately owned and managed FHLBanks, an attribute of the system that has always been one of its greatest strengths, by virtue of the local knowledge that benefits our members and their communities and the diversification of risk that benefits our investors.

Congress's geographic division of the markets served by the FHLBanks has historically ensured that each FHLBank has strong regional ties with its members, as noted above. This geographic division has also enabled the FHLBanks to work together cooperatively, without concern that sharing information and otherwise helping each other will work to any Bank's competitive disadvantage. Regular System-wide meetings among the FHLBank Presidents, as well as among officers in each functional area, ensure the sharing of information and best practices that benefit FHLBanks and their members nationwide. This support of each other would undoubtedly erode in a world where FHLBank geographic borders have blurred, notwithstanding the promises to share information that is a key element of the BPC's captive framework described in Section I above.

The FHLBanks also work together to support the Office of Finance (OF), including through directorships held by each FHLBank President. If all 11 FHLBanks are effectively in direct competition for all members, because any existing member (whether insured depository or insurance company) or any potential sponsoring parent (such as a REIT) can create a captive insurance company for the purpose of joining any FHLBank, then the basic structure of the OF Board would be called into question. Competing FHLBank Presidents would be in a difficult, if not conflicted, position to oversee the debt issuance strategy of the Office of Finance when they are working with ten direct competitors to do so. Further, the concept of joint and several liability – which is essential to the operation of, and enures to the benefit of, all of the FHLBanks in a regional, cooperative system – seems incongruous for a group of direct competitors.

As we indicated in our January 9, 2015 comment letter, we believe that the solution to this issue is not to ban captives from membership altogether. Rather, we believe that for any “pure” captive insurer³ that joins or has joined an FHLBank following the date of issuance of the Notice of Proposed Rulemaking on Members of the Federal Home Loan Banks (RIN 2590-AA39), the statutory “principal place of business” should be deemed to be the location of the primary business operations of the operating company whose officers and employees most directly control the insurance and investment operations of the captive.⁴ We believe that this PPOB standard, rather than “state of domicile,” should apply to captive insurers even though the captive insurer itself might have no employees or physical office of its own. This is the only

³ We believe that risk retention groups, unlike pure captives, should be considered “traditional” insurance companies, regardless of the section of state law under which they are organized.

⁴ This analysis should exclude an unaffiliated company that manages the captive's insurance operations by contract.

way to avoid the commoditization of FHLBank membership that will inevitably occur if the “shopping” among FHLBanks by captive insurers is permitted to continue. We have given thought to how this standard could be best worded, and would be happy to discuss with you our ideas in that regard.

To be clear, the Boston Bank would NOT support captive insurance company membership in the FHLBank System without a definition of PPOB for captives along the lines discussed above. We believe that the potential benefits of captive membership are far outweighed by potential damage to our regional, cooperative system that could be caused by unfettered cross-district competition for members of all types via low barrier-to-entry captive insurance company members.

III. REQUEST FOR A MORATORIUM

For the reasons set forth above, the FHLBank of Boston strongly believes that the current activity within the System of accepting new captive insurer members based on domicile is detrimental to the System. Moreover, we believe that this activity is occurring at an accelerated pace – by our calculations, all but one REIT-sponsored captive insurance company that has joined an FHLBank in recent years is domiciled in an FHLBank district other than where the sponsoring REIT is located. *We ask that the FHFA impose an immediate moratorium on new captive insurer members while it considers the above framework, and that it lift the moratorium only upon adopting a principal place of business standard that avoids the serious negative ramifications of a domicile-based approach.*

CONCLUSION

If the principal place of business issue is satisfactorily resolved in the manner described above, the FHLBank of Boston agrees to adhere to the framework described above with respect to any captive insurer member, 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,



Edward A. Hjerpe III
President & 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.⁵ 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.⁶ Moreover, state courts

⁵ 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>.

⁶ *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

have held that captive insurance companies are "insurance companies" and engage in the "business of insurance."⁷

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.⁸ Captive insurance companies also have reserves, surplus, policies, policyholders, and claims.⁹ 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.¹⁰ 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

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 06/17/2015), 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.").

⁷ *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 *bonafide* insurance company under income tax law).

⁸ *See supra* note 2.

⁹ *See id.*

¹⁰ *See* 12 CFR § 1263.3(a).

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.¹¹ This transfer reflects the desire of that 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.

¹¹ *See id.*

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."¹² 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.¹³ 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.

¹² FHFA Strategic Plan: Fiscal Years 2015-2019, p. 10.

¹³ <http://www.sec.gov/answers/reits.htm>.

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 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.¹⁴ 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.¹⁵

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.

¹⁴ Morrison and Foerster, "Mortgage REITS Poised to Benefit from Role in Emerging Housing Finance Market," May 2011.

¹⁵ Jody Shenn, "Pine River's Two Harbors Now Targets Non-Prime Mortgages," Bloomberg.com, November 5, 2014.

Table 1: REITS Balance Sheet Composition

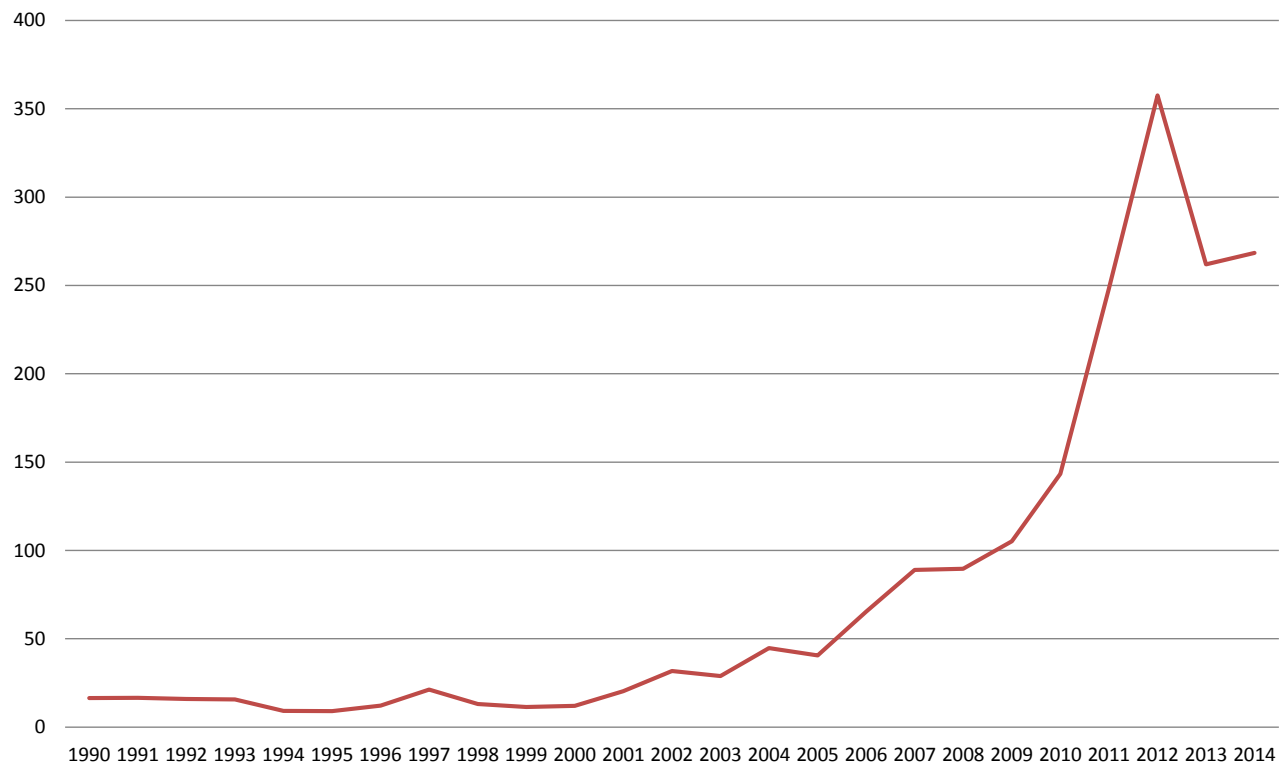
(\$ billions; amount outstanding at year end)

	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

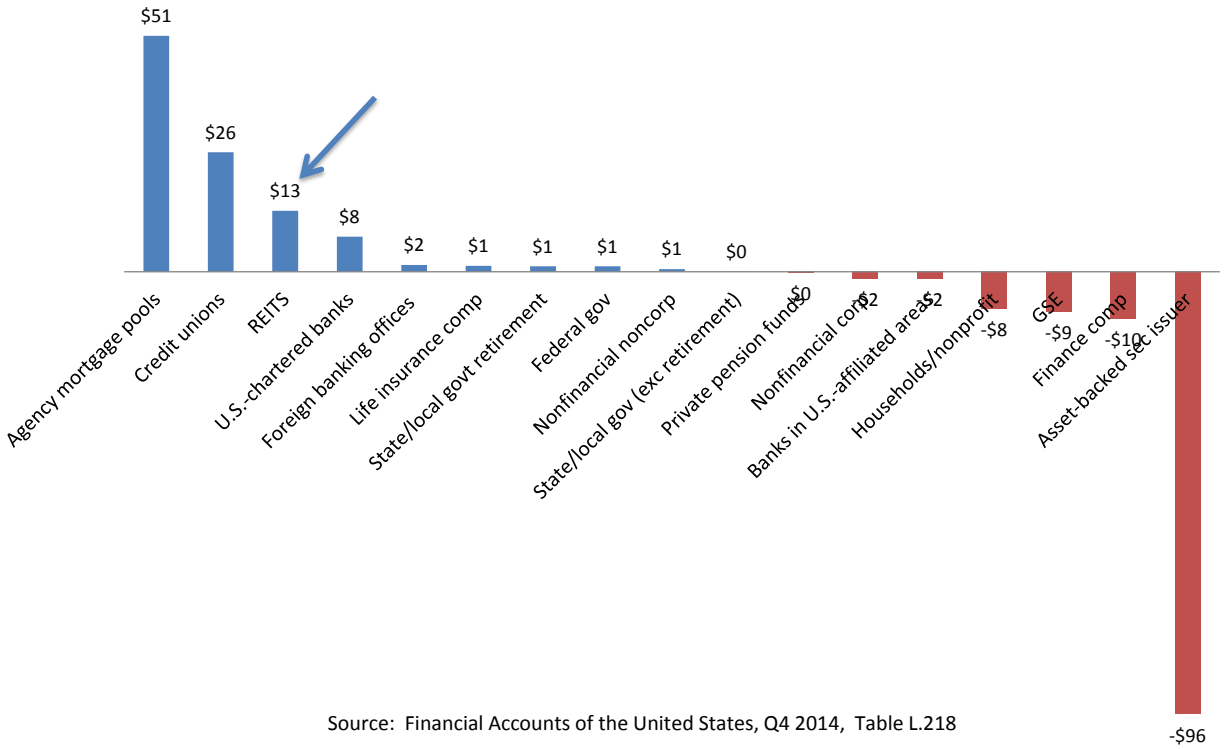
(\$billions; amount outstanding at year-end)



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