



Federal Home Loan Bank  
NEW YORK

July 24, 2015

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

Re: Establishing PPOB Membership Standards For Captive Insurance Companies to Ensure Mission/Consistency and Safety & Soundness

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 New York (New York or New York 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 New York 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 12, 2015), New York'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 (PPOB) 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. The New York Bank recognizes that this is a difficult and complex issue that cannot be resolved quickly. As such, we urge the FHFA, for safety soundness concerns related to forum shopping, to issue a directive suspending the processing of captive insurance membership applications that have out-of-district parents until the PPOB issue is finalized.

## **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.<sup>1</sup> 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;
- (iv) be in such financial condition that advances may be safely made to it;

---

<sup>1</sup> As described more fully in Section II below, the FHLBank of New York 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.

- (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. It Is Critical to Establish PPOB Standards For Captive Insurance Company Members**

The FHLBank of New York 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/charter (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 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 issue a directive suspending the processing of captive insurance membership applications that have out-of-district parents until the PPOB issue is finalized.**

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 the domicile/charter in the analysis of PPOB 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/charter. 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 FHLB membership in any of the 11 FHLBank 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 FHLB 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.<sup>2</sup> This has the potential to fundamentally alter the current regional, cooperative nature of the System, in a manner that deeply concerns us.

As noted, this may be accomplished at low cost with relatively low regulatory capital requirements, by establishing one or multiple captive charters, or, worse yet, by simply moving the captive's state of charter by re-domiciling the charter to another state. Captive chartering may be done for the sole purpose of changing FHLBanks districts because, unlike a traditional member, their retail presence, business operations and PPOB will not be disrupted by creating a captive membership. Traditional members having retail operations and are generally grounded

---

<sup>2</sup> 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.

in a FHLBank district. A charter/domicile membership option for traditional members does not trigger the same concerns because of the retail presence and established regulatory relationships mitigate the risk and ease of FHLB district shopping. However, the “friction” of chartering or moving a captive is far less than what is required to move an established traditional member. Although captive insurers are part of a valued member class, it is now far too easy to charter a captive insurance company as a way to forum shop FHLBanks or access multiple FHLBanks.

This is not a theoretical concern. As of March 31, 2015, the New York Bank has identified at least seven captive members which have the principal place of business of their parent firm in the New York District but belong to other FHLBanks. This phenomenon is occurring throughout the FHLBank System and the numbers continue to grow as more captives join.

A recent analysis prepared by another FHLBank estimates that as of mid-year 2015, 17 REIT captives have recently joined or applied in the System. Of those 17, only one had created a captive chartered in the same FHLB district where the captive’s parent PPOB resides. The trends are obvious - with bifurcation of charter/domicile versus PPOB, captives now have a choice to select or in the future change districts in ways that are unprecedented for the System. We have been approached by prospects (and their consultants) who are comparison shopping; i.e., they are knowledgeable about key advances, collateral policies, and underwriting differences among FHLBanks. This new development should be a concern to all FHLBanks.

Given the single source of funding and joint and several liability on FHLBank debt, these undue cross-district competitive pressures will act over time to systemically undermine our regionally-owned, cooperative-based System. Additionally, this places unnecessary added market pressure on FHLBanks looking for ways to grow advances, especially given that each FHLBank must work towards meeting the Core Mission Assets objectives as noted in the new Advisory Bulletin 2015-05, published on July 14<sup>th</sup>. The added pressure creates the very real potential for “a race to the bottom” or a FHLBank risks losing valuable advances business to another. In addition, the incentives for FHLBank managers to meet collectively to share best practices and discuss other matters of mutual importance will be reduced or eliminated if the FHLBanks effectively become competitors of each other for the business of members and prospects.

We believe forum shopping has the potential to commoditize 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 the regional nature of the FHLBank System could lead to rapidly increased consolidation of the FHLBanks.

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.

To address our concerns, the FHFA only needs to go back and apply the membership standards the Congress enumerated back in 1932. A member should have a strong actual physical nexus to the FHLBank district in which it is a member. This principle aligns with the geographical boundaries set up by the Federal Home Loan Bank Act ("Bank Act") Section 4(b) 12 U.S.C. § 1424(b), which reads:

**(b) Location requirement.** An institution eligible to become a member under this section may become a member only of, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's principal place of business, or of the bank of a district adjoining such district, if demanded by convenience and then only with the approval of the Director. (emphasis supplied)

Since the beginning, FHLBank members have had strong geographical ties to the districts in which they are members. This was a result of the historical ties that depository institutions and insurance companies had to the states where they were chartered. If the geographical outlines of the FHLBank System are to remain intact, members should belong to FHLBank districts based on the location of their actual principal places of business - that is, the "nerve centers" out of which their operations are conducted. The principal place of business of a member should be at a particular location and the member's business should actually be conducted from that location - and should be greater in some respect than at any other of its business locations that might exist. These principles should remain as viable today, in our age of sophisticated technological capabilities, as they did when the System was founded. Otherwise, the foundational structure of the FHLBank System will be undermined.

For captives, by statutory origin they are "captured" and controlled by their parent, and only offer insurance to affiliated companies. Thus, the PPOB test should be applied at the level of the captive's immediate or sponsoring parent.

Our view is reinforced by the comments of Assistant Legislative Counsel Mr. John O'Brien (a principal drafter of the Bank Act) in response to questions regarding the Bank Act at a Senate hearing in 1932:

[I]t was not the desire, say, for members in South Carolina to borrow of a New York bank, because it would mean too great a concentration at the New York bank. If the New York bank happened to do better than a South Carolina bank, all members would go there. There is the opportunity in the bill for a member whose principal place of business is in one district to belong to a bank in the adjoining district, but outside of that there is no provision. It is impossible under the terms of the bill for a company doing business in New York to belong to a South Carolina bank.<sup>3</sup> (emphasis supplied)

---

<sup>3</sup> Citing Hearings on S. 2959 concerning creation of the FHLBank System, 72<sup>nd</sup> Cong., 1<sup>st</sup> Sess (1932). At 199.

This fundamental approach on how System membership is suppose to work has now been compromised.

The FHFA, and its predecessor agencies, have a long-held position to reduce the risk of forum shopping among FHLBank members. When the Three-Part Test, now 12 CFR 1263.18(c)(1) was enacted in the late 1980s, it was carefully crafted to make sure members could not easily change districts to get more favorable advances, collateral terms, or pricing, higher dividends, or gain preferable or selective regulatory treatment. This was a major concern among the FHLBanks' Principal Supervisory Agents since each FHLBank, pre-FIRREA, had exam responsibility for FSLIC-insured thrifts. We still support the use of the Three-Part Test because it does allow FHLBank memberships to move, but it does only in a controlled, orderly fashion based on PPOB standards. Students of banking history will note that this Test was created in response to changes in banking laws that eased geographic limitations on the expansion of member banks. The FHFBA in the late 1980's needed to establish guidelines in order to preserve the fundamental geographic nature of the FHLBank System, and ensure that members were not able to forum shop to choose the FHLBank they wanted to join. The FHFA needs to achieve the same objective today: establish a set of guidelines that permit the FHLBank System to preserve our fundamental nature in the face of the evolution of the markets in which members operate.

### **III. Request for FHFA Action**

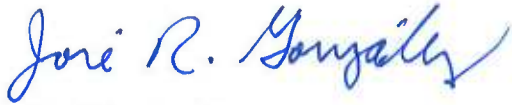
To create a workable PPOB standard for the captive insurance company membership, we have, as described in the New York FHLBank comment letter on the NPRM dated January 12, 2015, enumerated uniform standards that include an evaluation of where the physical business actually resides, taking into account the operations and decision making of the captive's sponsoring parent and affiliates.

We would be pleased to work with FHFA, other FHLBanks and industry stakeholders to develop a workable uniform PPOB standard for the parents of captive insurance companies. If this is accomplished then the risk of forum shopping will be minimized and the statutory directive of having a geographically based FHLBank System will be preserved.

The New York Bank strongly believes that resolving the PPOB issue is fundamental to the sustainability of the system. **As such, we urge the FHFA to issue a directive suspending the processing of captive insurance membership applications that have out-of-district parents, including captives for any depository members, until the PPOB issue is finalized.**

We thank you for allowing us the time to present additional thoughts on this important concern which is to assure, in conformity with the Bank Act and for fundamental reasons of safety and soundness, that FHLBank membership is solidly anchored to a member institution's PPOB.

Very truly yours,



José R. González  
President and  
Chief Executive Officer

Attachments – Appendix A & B

## 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.<sup>4</sup> 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.<sup>5</sup> Moreover, state courts have

---

<sup>4</sup> 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>.

<sup>5</sup> *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 06/17/2015), [http://www.naic.org/cipr\\_topics/topic\\_captives.htm](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

held that captive insurance companies are "insurance companies" and engage in the "business of insurance."<sup>6</sup>

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.<sup>7</sup> Captive insurance companies also have reserves, surplus, policies, policyholders, and claims.<sup>8</sup> 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.<sup>9</sup> 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.

---

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.").

<sup>6</sup> 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).

<sup>7</sup> See *supra* note 2.

<sup>8</sup> See *id.*

<sup>9</sup> See 12 CFR § 1263.3(a).

This discretion is also consistent with the transfer of the approval of membership applications from the predecessor agency of the FHFA to the FHLBanks.<sup>10</sup> 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.

---

<sup>10</sup> *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."<sup>11</sup> 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.<sup>12</sup> 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.

---

<sup>11</sup> FHFA Strategic Plan: Fiscal Years 2015-2019, p. 10.

<sup>12</sup> <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.<sup>13</sup> 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.<sup>14</sup>

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.

---

<sup>13</sup> Morrison and Foerster, "Mortgage REITS Poised to Benefit from Role in Emerging Housing Finance Market," May 2011.

<sup>14</sup> Jody Shenn, "Pine River's Two Harbors Now Targets Non-Prime Mortgages," Bloomberg.com, November 5, 2014.



**Table 1: REITS Balance Sheet Composition**

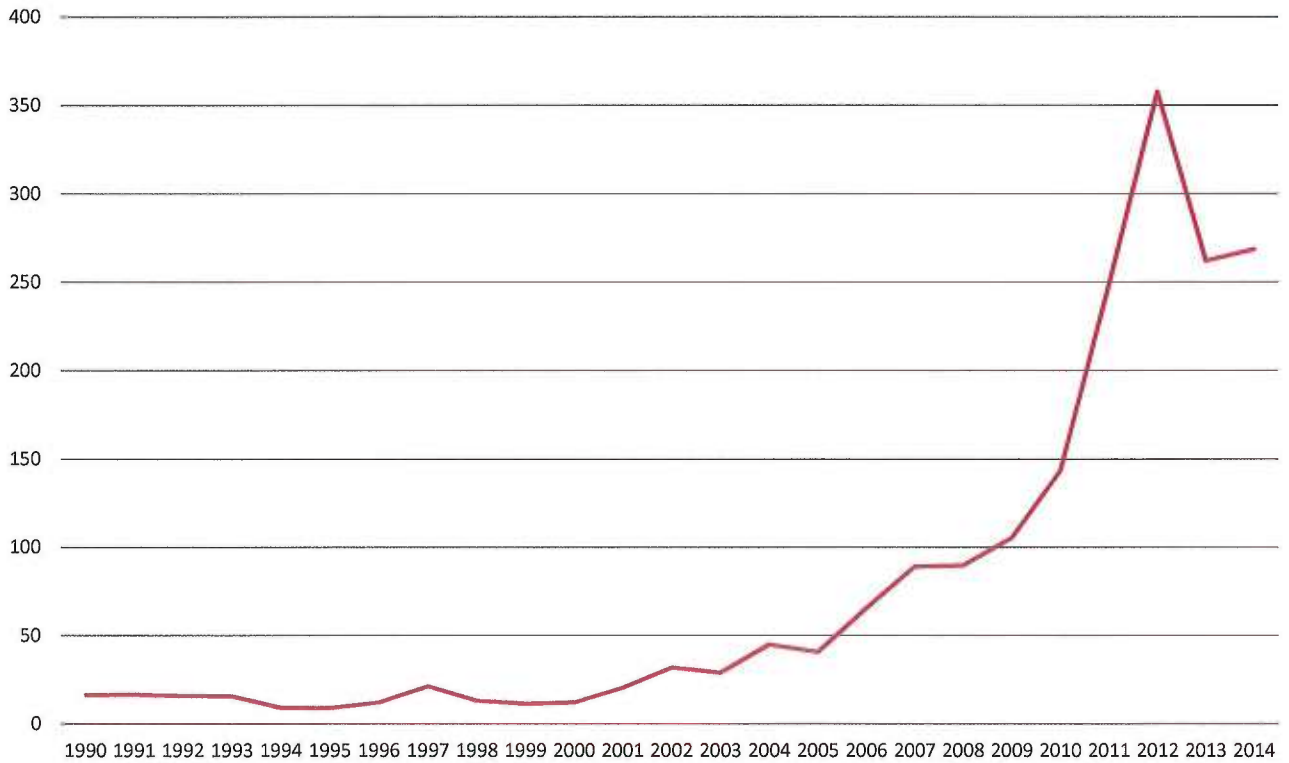
(\$ billions; amount outstanding at year end)

	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%	<b>46%</b>
Mortgages	\$65	11%	\$199	31%	\$227	32%	<b>25%</b>
Home	\$27	4%	\$23	4%	\$36	5%	<b>4%</b>
Multifamily	\$2	0%	\$2	0%	\$4	1%	<b>0%</b>
Commercial	\$36	6%	\$174	27%	\$187	27%	<b>20%</b>
Agency MBS and Mortgages	\$422	71%	\$461	72%	\$496	70%	<b>71%</b>

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

**Chart 1: Agency MBS Holdings of REITs**

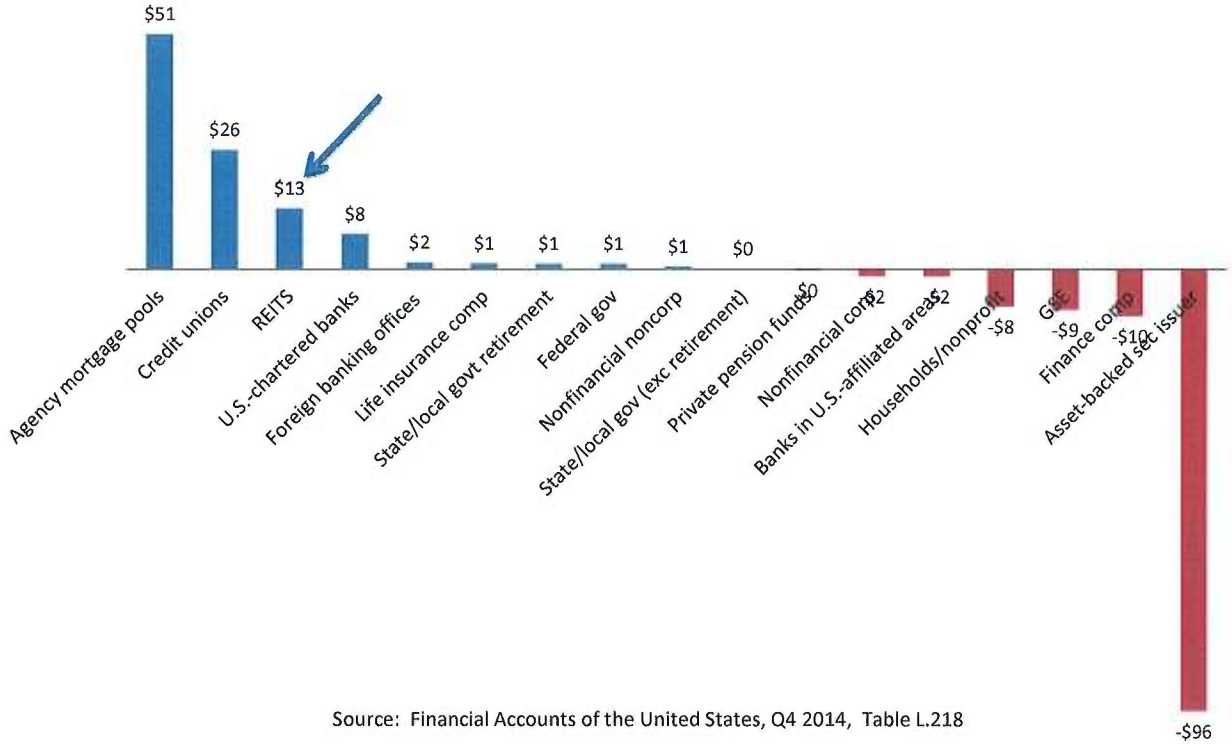
(\$billions; amount outstanding at year-end)



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