Captives No Longer Eligible for FHLB System Membership

In early January, the Federal Housing Finance Agency (FHFA) released official changes to the rules governing membership in the Federal Home Loan Bank (FHLB) system. The new rule bars captive insurance companies from membership eligibility in FHLBs. It took effect in February.

About the FHLB System

The types of captives that are affected by the rule change are those owned by real estate investment trusts (REITs) – private or publicly held companies that own or finance income producing real estate. By themselves, REITs are not allowed membership into the FHLB system, but they can access the system through their captives. As FHLBs can generally offer better terms than traditional banks and bond markets for dependable funding, it can be an important source of liquidity for the alternative risk transfer market.

Insurance companies have been accepted as members in the FHLB system since it was established in 1932 by Congress. It was created to be a steady source of funding in the housing market through good and bad economies and is a cooperative system made up of eleven regional lending institutions that are owned by their members – more than 7,500 financial institutions in the United States – and is regulated by the federal government. FHLB regulating has been

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governed by the FHFA since 2008 when that agency was created through the Housing and Economic Recovery Act of 2008.

The eleven FHLBs are conservatively managed with a long-term view of financial investments. Because they are cooperatives, they reinvest any profits, keeping costs low. Small financial institutions and community banks rely on loans from FHLBs to help maintain liquidity. The FHLB system is worth over $800 billion and, after the U.S. Treasury, is the biggest U.S. bond borrower.

According to a speech made by the FHFA director, Mel Watt, in May 2014, loans made by FHLBs to insurance company members increased from one percent in 2000 to 14 percent in 2013. While insurance companies have always members been in the FHLB system, they now accounted for a larger portion of the loans awarded. The growth in member insurance companies receiving loans is reflected in the growth of the insurance sector in the overall financial marketplace. Watts cited lingering concerns about the health of the insurance marketplace after the financial fallout in 2008. When the changes were first proposed, Watts indicated that the new rules were meant to make sure that FHLBs can continue to safely support the housing financing marketplace.

Membership Rule Changes

The changes that were proposed on September 2, 2014 included establishing a "quantitative test" requiring all members to hold at least one percent of the assets in home mortgage loans on an on-going basis; required certain members subject to ten percent residential mortgage loans adhere to the requirement on an on-going basis; clarified the definition of an insurance company's primary place of business to determine regional membership; and defined "insurance company" as a company that primarily underwrites insurance for nonaffiliated third parties.

When the proposed changes were released, a 60 day comment period opened. However, the comment period was extended and closed in early January 2015. The FHFA received more than 1,300 responses both for and against the proposed changes. The captive industry rallied to oppose the changes with several captive associations weighing in on the topic and encouraging their members to comment.

After a full year the FHFA finally released its update to the membership rules for the FHLB on January 12, 2016. Two parts of the proposed rule that are being implemented is the section concerning captive insurance companies and defining an insurer's primary place of business to determine regional membership. FHLB membership rules now include a definition that explicitly excludes captive insurers. Not implemented were the sections pertaining to members retaining minimum levels of investment in specified residential mortgage assets. Captives that were members prior to September 2, 2014 have five years in which to withdraw from the FHLB system. Captives that were admitted after that date have one year in which to terminate FHLB activity.

In a FAQ issued by the FHFA on the same day as the ruling was announced, it was indicated that captive insurers could be circumventing the "Bank Act." The statement went on to explain, "The number of entities that are otherwise ineligible for membership in a FHLBank establishing captive insurance subsidiaries as conduits to get low-cost FHL Bank funding for the ineligible entity has increased considerably in recent years... FHFA is concerned that this practice will continue to grow and there is no reason to believe it will not grow to include entities other than REITs, such as hedge funds, investment banks and finance companies, some of which have already inquired about establishing captives to gain access to the FHLBank System."

More Than 1,000 Comment Letters

In the comment letters received by the agency, banks, credit unions, insurers and housing associations were primarily concerned with the parts of the proposed rules not implemented – the financial requirements. The argument being that the requirement would be a hardship to small banks, limiting liquidity at a time when it is more necessary than ever. Insurance companies, such as life or health insurance companies, argued against the requirement that the majority of a company's interests be in home loans. Community housing associations were also very vocal, arguing that while they themselves are not members, imposing such rules would impact their ability to provide affordable housing. Besides the consistent argument against investment requirements, many commenters supported the continued membership of captives.

Overall, the letters decried the idea of limiting membership at a time when liquidity in the housing market seems to be drying up. One letter, submitted by Professor Elliot A. Spoon, a former independent director for the Indianapolis FHLB and a professor at Michigan State University College of Law, summed up the opposition to the proposed rule succinctly, "This proposal is truly a solution in search

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of a problem. While I am sure the proposal was made with the best intentions, it is theoretically-driven without regard to the facts on the ground. This proposal will not solve any particular problem, but has the capacity to do great harm to a Home Loan Bank System that continues to flourish precisely because it has proven to be flexible to meet the changing liquidity needs of its members and the mortgage market. No proposal that will reduce membership, reduce liquidity access and create uncertainty should be adopted."

FHLB Bank Presidents' Conference

The Bank Presidents' Conference (BPC) of the eleven Federal Home Loan Banks put together a working group late last spring to define membership parameters for captive insurers in the FHLB system in direct contrast to the proposal set forth by the FHFA. The working group came up with a framework that would establish criteria for captive insurance companies seeking membership. In July 2015, each of the eleven regions submitted to the FHFA letters in support of captive insurance company membership into the system along with the framework that was developed.

The letters submitted by the presidents use much of the same boilerplate text and each regional president included the following statement in their letter: "The BPC believes that continuing to permit captive insurance companies to access the FHLBs is important to support the evolving housing finance market and fulfill the FHLB's mission... [REITs], particularly those investing in mortgage assets [MREITs]... 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 FHLBs and supporting the expansion of housing opportunity and liquidity in the United States."

Legislative Action

In opposition to the FHFA's proposed membership rules, Rep. Blaine Luetkemeyer (R-MO) introduced into Congress last October H.R.3808 (To require the withdrawal and study of the Federal Housing Finance Agency's proposed rule on Federal Home Loan Bank membership and for other purposes). By January, the bill had 45 cosponsors. The Bill is simple enough. It requires only that the FHFA withdraw its proposed membership rule change and requires that the Government Accountability Office report to Congressional committees on the impact the rule would have on the FHLB system. The bill was introduced on October 22, 2015 and was then referred to the House Committee on Financial Services. No further action on the bill has been taken at this time.

On the day that the FHFA's released the rule changes, Rep. Luetkemeyer issued a statement on his official website. "While I am pleased with parts of the final rule, I am disappointed that it forces captive insurers out of the Federal Home Loan Bank system. It is Congress, not FHFA, which has the authority to set membership standards for the system. Not only is this a blatant violation of the rule of law but it is a decision based on little evidence or analysis," he says in the statement. "We must ensure that decisions impacting our housing system are made in a thoughtful and educated manner and make sure that entire segments of industry are not exiled from participation in the Federal Home Loan Bank system."

Recourses

Other reactions have been equally dissatisfied with the FHFA's ruling. According to Mike Teichman, a partner with the law firm of Parkowski, Guerke & Swayze, P.A, "Notwithstanding the 1,000 or so comment letters opposing the rule change, the FHFA was unpersuaded b the many arguments against the rule. We don't know why they have dug in their heels, but we understand that they are expecting litigation over the new rule and have decided not to grandfather existing captives in order that they are not accused of taking inconsistent positions with different captives and captive owners."

At this time it is unknown if or from which quarter legal action will come. In all likelihood, legal action will come directly from REITs themselves, with the support of the larger captive community. Any legislative intervention by Congress will likely be stalled due to the current election cycle. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at www.karriehyatt.com.