Proposed Rules for FHLB Membership Could Bar Captives by Karrie Hyatt

On September 2nd, the Federal Housing Finance Agency (FHFA) proposed substantial changes to rules governing membership in the Federal Home Loan Bank (FHLB) system which would effectively bar captive insurance companies from participating. The proposed rule changes come during a three month moratorium on accepting captives as members to the 12 FHLBs that began in June.

In May, the FHFA director, Mel Watt, warned in a speech at the FHLBs Directors Conference that captive insurance membership raised a number of red flags "related to the safety and soundness and access to the system."

The changes proposed in September includes 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; requires certain members subject to ten percent residential mortgage loans adhere to the requirement on an on-going basis; clarifies the definition of an insurance company's primary business place to determine regional membership; and defines "insurance company" as a company that primarily underwrites insurance for nonaffiliated third parties. This last rule change would effectively bar captive insurers from participating in the program. Companies not able to meet the last requirement would be gradually removed from membership over five years.

The FHLB system was established in 1932 by Congress to be a steady source of funding in the housing market through good and bad economies. It is a cooperative system made up of twelve 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. FHLBs have been regulated by the FHFA since 2008 when that agency was created through the Housing and Economic Recovery Act of 2008.

The 12 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 the speech made by Watts in May, loans made by FHLBs to insurance company members have increased from one percent in 2000 to 14 percent in 2013.

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Insurance companies have always been allowed membership in the FHLB system, but are now accounting 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.

Yet lingering concerns remain about the health of the insurance marketplace after the financial fallout in 2008. The proposed change to membership rules by the FHFA are meant to make sure that FHLBs can continue to safely support the housing financing marketplace, according to Director Watts.

The types of captives that would primarily be affected if the rule changes go into effect 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.

As seen in recent months, the suggested rule changes by the FHFA might be construed as a backlash against the exponential growth captive insurers in recent decades. As described recently in previous issues of The Self-Insurer, captives have been getting a lot of negative attention lately – from the National Association of Insurance Commissioners to the Federal Insurance Office to independent associations and researchers. Much of the extra scrutiny has been due to the fast growth of captives and because critics feel that they operate "under the radar" or are not fully regulated by their domicile.

According to Mike Teichman, a partner with the law firm of Parkowski, Guerke & Swayze, P.A, the FHFA is concerned that "Captive insurance companies are not regulated in a transparent manner relative to traditional insurance companies and may be at greater risk of failure if its parent company becomes financially impaired, because the captive serves its parent rather than third parties."

"These concerns are misplaced," he continued, "While captive insurers are regulated in a manner that is typically more streamlined and efficient than the regulation of traditional insurance companies, captive insurers are nevertheless closely and carefully regulated by state insurance departments and their capital requirements are established independently of the relative financial condition of the parent-insured."

Richard Smith, president of the Vermont Captive Insurance Association (VCIA), doesn't think there is a real threat from captives that are members of the FHLB, "But I think [the proposed membership rule changes are] a mix of potential real concerns on certain captives that might be participating in the FHLB and more broadly misunderstanding of captives and how they are regulated."

The VCIA issued a legislative alert to its members a few days after the proposed changes were announced. The letter expressed concern about the changes stating that the new membership definition "categorically excludes captives that might otherwise qualify to participate in the FHLB program. It provides no legitimate reason to keep captives out of this market."

Many banks, insurers and mortgage investment firms are also expressing dismay with the FHFA's changes. The initial comment period was limited to sixty days, which would have ended November 12, but was extended by an additional sixty days to January 12, 2015, due to industry pressure.

The U.S. Senate Banking Committee held a hearing on September 16, 2014 titled, "Examining the state of small depository institutions." While the hearing was not specifically about the proposed rule changes by the FHFA, many of the industry insiders testifying took the opportunity to condemn them. Representatives from Independent Community Bankers of America, Credit Union National Association, National Association of Federal Credit Unions, and the Center For Responsible Lending spoke out against the proposed changes.

Jeff Plagge, the president and CEO of Northwest Financial Corp. and chairman of the American Bankers Association was particularly expressive in his dissent. In his testimony, he stated, "The proposal would also redefine captive insurance companies as no longer eligible for system membership. The types of entities eligible for membership in the system are delineated in the statute, including insurance companies. The proposed rule, therefore, runs counter to the plain meaning of the statute and declares captive insurance companies ineligible... Access to liquidity, particularly for community banks, is critical. This rule is unnecessary, runs counter to the authorizing statute, and would potentially put at risk an important source of liquidity for banks at a time when such liquidity is vitally necessary."

To many industry representatives, the rule change could negatively affect an already stalled housing market. The FHLB financial model has been very successful over the course of its more than eighty years in operation. For the FHFA to implement these major changes in membership requirements now appears to be creating a solution for a problem that doesn't exist.

"If the proposed rule is implemented," said Teichman, "It would deprive captives, in particular those affiliated with REITs, of an important source of liquidity. As to the REITs, the disallowance of funding REIT-owned captives through FHLB advances may impede the willingness and ability of REITs to assume mortgage credit risk. A consequence that seems contrary to the federal housing finance system."

At this time it is unclear whether the new membership rules will be implemented. The opposition has been vociferous and fairly united. As of early November, there were already more than 160 comments already registered on the FHFA website (www.fhfa.gov). ■

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