



January 9, 2015

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th St., S.W., Eighth Floor
Washington, D.C. 20024

RIN: 2590-AA39

Dear Mr. Pollard:

On September 2, 2014, the Federal Housing Finance Agency (FHFA) released for notice and comment a proposed rule (the Proposal) concerning membership in the Federal Home Loan Bank System (the System). The Mortgage Bankers Association¹ (MBA) briefly addressed the Proposal in our comment letter in response to FHFA's Strategic Plan for Fiscal Years 2015-19,² and we appreciate the opportunity to address the issue in greater detail below. MBA also appreciates the extension of the comment period by 60 days in recognition of the significant business, policy and legal issues raised by the Proposal.

EXECUTIVE SUMMARY

For the reasons stated below, the Proposal is contrary to a plain reading of the Federal Home Loan Bank Act (the Act) and congressional intent. The Proposal also raises significant public policy concerns regarding the System's statutory membership requirements and its future role in the housing finance market.

The housing finance industry has changed significantly since the Act was signed into law in 1932. Real estate investment trusts (REITs), which were not even in existence at the time, have become significant investors in residential mortgages. Moreover, an ever-greater share of the market now relies on independent mortgage bankers (IMBs) for originating and servicing mortgage loans. These entities, like many banks and thrifts that are currently members of the System, are committed to residential housing finance,

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

² Submitted on September 15, 2014.

and in the case of REITs, are limited by law to investing in real estate or real estate loans.

Further, the housing finance market as a whole is approaching a dramatic turning point. The Federal Reserve (the Fed) has accumulated more than \$1.7 trillion of agency mortgage-backed securities (MBS) over the past five years, in many months purchasing more than total net issuance.³ As the Fed unwinds this program over the coming months, private capital will be required to play a larger role in the mortgage market in order to facilitate growth in the housing market and economy as a whole. Further, as the debate over the future of Fannie Mae and Freddie Mac continues, the one near-certain outcome is that private capital will hold a substantially greater share of residential mortgage credit risk than current levels.

The System has the potential to play a key role in the future of housing finance because it can bring large amounts of long-term, global capital to the U.S. housing finance market, much like Fannie Mae and Freddie Mac.⁴ A key difference between the System and Fannie Mae/Freddie Mac, however, is the allocation of risk among the counterparties; whereas lenders who sell to Fannie Mae or Freddie Mac retain a residual exposure through their representation and warranty obligations, originators and investors who rely on funding from the System directly retain a substantial amount of the loan-level credit risk associated with the eligible assets. Thus, the System is perfectly suited to having a central role in the future of the housing finance system because it can provide liquidity to lenders and investors while ensuring that most if not all of the credit-related losses are borne by private capital.

MBA believes that FHFA should revise its current regulatory posture and expand the System's impact to better fulfill its mission. The housing finance system going forward requires a policy of inclusion that builds upon the capital of all mortgage lenders and investors while protecting the taxpayer. Adopting this approach will lead to increased competition among lenders nationwide, enabling borrowers to obtain the best services at competitive prices. Moreover, it will facilitate market diversity, reducing the risk that localized business practices could contribute to a systemic event. Finally, this approach will facilitate greater private capital participation in assuming credit risk by allowing industry participants to better match their funding terms with the expected life of the asset, improving stability and liquidity.

MBA believes that FHFA currently has the authority to adopt a policy of inclusion, and we look forward to working with FHFA and other stakeholders to develop these policies to best serve the needs of our 21st century housing market.

³ Michael Fratantoni, Ph.D., *Who Will Own Mortgage Assets?*, MORTGAGE BANKERS ASSOCIATION (November, 2014).

⁴ While Fannie Mae and Freddie Mac issue both corporate debt and pass-through MBS, the System issues only consolidated, joint and several liability debt through its centralized Office of Finance.

COMMENTS

MBA has significant policy and legal concerns with the Proposal. The Proposal would make several material changes to the requirements for becoming and remaining a member of the System, precluding many currently-eligible potential members from ever joining. The proposed changes would also result in the involuntary termination of existing members in good standing, an unprecedented step that would deprive many current members of rights they currently enjoy, harm the capital position of the System and undermine the System's statutory mission. Many of the members who would be involuntarily terminated are significant housing finance market participants, originating and purchasing loans, affordable housing bonds and other mission-centric assets.

The Proposal, if adopted as drafted, would make the following changes to System eligibility requirements:

- Limit the definition of "insurance company" to exclude captive insurers and make captive insurers categorically ineligible for membership in the System.
- Establish an on-going mortgage asset test requirement. Members would be required to hold not less than one percent of their respective total assets in long-term home mortgage loans on an on-going basis. Some members⁵ would be subject to an on-going requirement to hold not less than 10 percent of their respective total assets in residential mortgage loans on an on-going basis.
- Establish new criteria for determining the principal place of business for some members, provisions on which MBA requests greater clarity.

MBA will address each proposed change in turn below.

FHFA Should not Prohibit Captive Insurers from Joining the System

MBA strongly objects to the proposed prohibition of captive insurance companies obtaining or maintaining membership in the System. The System is well-equipped to, and indeed currently does, perform counterparty due diligence on insurance companies that apply for membership, regardless of the ownership structure. The Proposal not only usurps this function to no clear benefit, but contravenes decades of congressional intent. Further, prohibiting captive insurers would undermine the mission of the System itself and significantly harm the capital position and future business of several individual Banks. This step is also unnecessary because FHFA retains an element of control over the membership approval process through the assignment of docket numbers and other procedural measures, which allow it to ensure that prospective members are in a position to further the goals and mission of the System.

⁵ Members that are insured depository institutions and who joined the System after 1988. Both asset requirements allow for securities backed by qualified collateral to count toward the threshold.

In light of these concerns, MBA strongly recommends that FHFA withdraw the Proposal entirely and instead engage with stakeholders to develop inclusive policies to best fulfill the System's mission.

Captive Insurers Support the Housing Finance Market

To date, FHFA has been unclear regarding its precise concerns with captive insurers as members in the System. The Proposal notes that capital advanced to captive insurers may be used by affiliated parties that are not themselves eligible for membership, such as in the case of captive insurers owned by REITs or IMBs. The Proposal also refers to safety and soundness concerns, particularly related to transparency of financial condition and the nature of the guarantee offered by the parent company.⁶

MBA believes that the safety and soundness concerns noted in the Proposal are misguided. It is worth mentioning that MBA and several of its members met with FHFA officials to discuss this issue.⁷ During the course of the meeting, FHFA's legal representative indicated that FHFA had no systemic, safety and soundness, or other economic concerns with REIT-owned captive insurance companies as members of the System.

Nevertheless, captive insurers owned by REITs and IMBs make the System stronger and are consistent with FHFA's mandate to ensure the System fosters a "liquid, efficient, competitive, and resilient national housing finance market."⁸ Captive insurer members further the System's mission by contributing up-front and activity-based capital and by reinvesting advances into the housing finance market.⁹ FHFA correctly notes that REITs have recently formed captive insurers and have used those affiliates to benefit from advances provided by the System to the member company.¹⁰ However, the activities at issue directly further the System's mission by financing the origination and acquisition of mission-centric assets like residential mortgages and affordable housing bonds, acting as a key liquidity channel for the housing finance system.¹¹ Each Bank receives capital contributions in proportion to the amount of funding provided to a member. This expands the membership base and market for advances and actually makes each Bank more safe and sound, benefiting existing members and the System alike.

As noted above, the advances provided to members, including captive insurers owned by REITs or IMBs, are secured financings and are significantly over-collateralized by statutorily-eligible, mission-centric collateral. The terms on which the individual Bank

⁶ The Proposal at 27.

⁷ The meeting was held at FHFA offices on November 12, 2014 from 1:00 - 2:15pm

⁸ HERA, §1102(a).

⁹ Notably, even if the captive insurer is not owned by a mortgage market participant, it may only obtain advances backed by "eligible collateral," a classification largely comprised of residential mortgage assets.

¹⁰ At least one MBA member uses a captive insurer as part of an affiliated insurance brokerage, presenting another context in which captive insurers may be used by mortgage originators and investors.

¹¹ For purposes of this comment letter, residential mortgages includes both whole loans and mortgage-backed securities.

will lend to a particular member vary throughout the System. However, each Bank considers both the credit quality of the member **and** the quality of the eligible assets posted as collateral when setting the price and term of the advance. These counterparty risk-management procedures are extremely safe; as Moody's noted in August, 2013 "no FHLBank has ever experienced a loss on an advance."¹² Finally, FHFA retains ultimate control over the entities which are approved as members of the System through oversight of the member application process, such as docket number assignment. This ensures that FHFA retains visibility into the members to whom the System is providing advances, as well as the assets that will be used as collateral.

In turn, the housing market as a whole benefits as it transitions toward a market where the bulk of mortgage credit risk is borne by private capital. The System is uniquely positioned to offer advances over time periods that align with the expected life of mortgages and MBS, providing stable access to credit and facilitating more competition among originators and investors. The ability to better match funding terms with the expected life of the mortgage asset or affordable housing bond being acquired will help encourage more private capital to invest in mortgage credit risk and housing finance generally, fulfilling a key policy goal of the Obama Administration and Congress.

The overcollateralized nature of System advances is coupled with a cooperative structure that ensures members have "skin in the game" and a corresponding interest in the health of the System. Members must purchase capital upon joining the System, and members who take advances must contribute additional capital in proportion to the amount borrowed. Each Bank sets the capital levels consistent with their long-term capital plan, allowing the Banks to independently manage their capital consistent with their membership profile and business activities. The combined structure provides unique security against counterparty risk, ensuring that substantial private capital stands ahead of the System if any losses are realized.

Prohibiting Captive Insurers Would Contravene Congressional Intent

The Act makes "**any** . . . insurance company" eligible for membership in the System, subject to the membership application process and corresponding due diligence by the respective Bank.¹³ This has been the case since the Act was originally signed into law in 1932 and has remained unchanged despite significant amendments having been enacted since, particularly those enacted in 1989,¹⁴ 1999,¹⁵ and 2008.¹⁶ It is worth noting that the 1989 and 2008 amendments to the Act significantly expanded membership eligibility, illustrating a clear intent to broaden the System's membership

¹² Moody's Investors Service, *Federal Home Loan Bank System: Frequently Asked Questions*, August 1, 2013.

¹³ 12 U.S.C. § 1424(a)(1) (emphasis added). This paragraph sets forth examination and operational criteria which act as a qualifier on the enumerated entity types. However, these provisions will not be discussed because they are not relevant to the Proposal.

¹⁴ Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

¹⁵ Graham-Leach-Bliley Act.

¹⁶ Housing and Economic Recovery Act (HERA).

base.¹⁷ Further, the Housing and Economic Recovery Act of 2008 (HERA) was enacted during the depths of the worst financial crisis since the Great Depression, yet the statute expanded rather than limited System membership guidelines.

In the Proposal, FHFA notes that captive insurance companies were not in existence in 1932, drawing from that the inference that captive insurers were not contemplated as being within the scope of “insurance company” for purposes of the Act.¹⁸ However, captive insurers have been utilized in the United States since the 1950s and were certainly known to Congress as it repeatedly chose to retain the unqualified phrase “any . . . insurance company” while debating substantive legislative amendments to the Act.

FHFA should not presume to act in Congress’ place to narrow the scope of a critical component of the housing finance system. Rather, as noted above, now is the time for a policy of inclusion which uses existing authority to further the System’s mission and expand its impact.

FHFA’s Proposed Distinction is Ambiguous and Arbitrary

MBA is also concerned by the Proposal’s arbitrary and ambiguous definition of captive insurers for purposes of System membership. The term “captive insurer” is defined by omission as “a company that is authorized under state law to conduct an insurance business, but that does not meet the definition of ‘insurance company’” under the Proposal.¹⁹ The Proposal then defines “insurance company” as “a company whose primary business is the underwriting of insurance for nonaffiliated persons or entities.”²⁰ Notably absent from this consideration is a definition of what it means to be “nonaffiliated,” raising the risk that many mutual insurance companies could be impacted because they are owned by their policyholders.²¹ Also left unclear is the meaning of “primary business” or how FHFA would go about applying this standard.

Congress authorized insurers to become members of the System without qualification as to the line of business in which the insurer was engaged and with the knowledge that the insurance business may be structured in many different ways. Congress further delegated insurance regulation to the states, delegation which includes the authority to approve and regulate insurance companies, including captive insurers.²²

¹⁷ FIRREA added insured commercial banks, insured credit unions, and insured savings and loans, while HERA authorized Community Development Financial Institutions.

¹⁸ The Proposal at 24.

¹⁹ The Proposal at 90.

²⁰ The Proposal at 90.

²¹ Prior to passing the Act, Congress provided various tax exemptions for insurance companies that were owned by their policyholder(s). *See generally*, The Revenue Act of 1928 §103. This clearly indicates that Congress contemplated insurance businesses that were restricted to affiliated persons when drafting the membership eligibility requirements under the Act.

²² 15 U.S.C. § 1012. This delegation should be viewed as an endorsement of the states’ role in approving insurance companies. At the very least, it should further indicate Congress’ intent that “insurance companies” be interpreted to include all state-chartered insurance companies, however structured.

Conversely, the Proposal would artificially divide insurers into two categories, while the key analytical standard of how an insurer or affiliate's primary business would be determined is left unclear and subject to change by FHFA at any time. Such a broad and ambiguous definition may also impact non-captive insurance companies, including those whose business model involves investment in housing finance, by placing restrictions on subsidiaries or affiliates. This would inevitably give rise to confusion and unpredictability as firms attempted to manage their businesses and affiliates in a compliant manner and could result in similarly situated institutions receiving disparate treatment based on how the business is organized. Simply put, this result is unworkable.

The Proposal also suffers from the uneven application of FHFA's regulatory powers. FHFA arbitrarily singles out captive insurers as "financing conduits" because they transfer System advances to non-member entities through intercompany transfers, and disregards without evidence the possibility that other eligible entities have been and could continue to be utilized for a similar purpose.²³ In no other way is FHFA seeking to limit the manner by which a member utilizes its funding, nor does it explore the ratio of advances to direct business activities for members other than captive insurers.²⁴ Nor does FHFA address intercompany transfers themselves, resulting in the discriminatory outcome that some eligible entities are allowed to transfer funds within a corporate family, but not others. This approach is patently unfair, and contrary to congressional intent and public policy because of the clear nexus between REIT and IMB-owned captive insurers and the System's mission.

The Proposal is rooted in poor public policy and beset by an unworkable construct. For these reasons, MBA strongly objects to the prohibition on captive insurers from joining or remaining members of the System. FHFA should instead make use of its existing authority to work with mortgage lenders and investors of all types to help expand access to credit and bring additional private capital into the housing market.

The On-Going Asset Requirements Will Undermine the System

In addition to prohibiting captive insurers, the Proposal would institute a new on-going asset test requirement. Members would be required to hold not less than one percent of their respective total assets in long-term home mortgage loans on an on-going basis. Some members would be subject to an on-going requirement to hold not less than 10 percent of their respective total assets in residential mortgage loans on an on-going basis.²⁵ While these ratios are consistent with the statutory requirement prospective

²³ The Proposal at 26.

²⁴ Compare The Proposal at 25 (directly comparing the advances obtained by captive insurers to their operations) with 26 (accepting without analysis that it is "unlikely" that other eligible institutions would be similarly situated).

²⁵ *Supra*, at 2.

members must meet in order to be eligible to join the System, these tests were never designed or intended to be imposed on an on-going basis.²⁶

This provision could undermine the System in three ways. First, it could facilitate imprudent decision-making as members manage their business with an eye toward maintaining this ratio at all times rather than solely focusing on the most prudent business decisions.²⁷ Community banks may have a particularly hard time given the limits of their geographic footprint. A related concern is that the *de facto* asset floor would serve as a disincentive for eligible entities to join the System because of concerns that FHFA would effectively punish safe and sound business practices. Finally, redefining on-going membership criteria in such a fundamental way creates a slippery slope that could cause many members to reduce their activities with the System.

The Proposal's approach is a sea change from past policy, leading to the very real concern that additional dramatic changes could be forthcoming. Members will naturally plan for the worst-case outcome and reduce their reliance on the System in anticipation of being the next member class caught below a threshold. This not only undermines the System's mission but its safety and soundness as well; as members reduce their advance borrowings or decline to join, the System is deprived of capital. As a result, the System becomes financially weaker and less able to provide liquidity to support residential mortgages – in short, its mission will be undermined. Such an outcome cannot be reconciled with the plain meaning of the Act or FHFA's duty to ensure a liquid and resilient national housing market.

FHFA should not be in the business of effectively directing capital or asset management decisions of companies it does not regulate, particularly when those companies are independently subject to prudential regulation at the state and federal level. Therefore, MBA recommends abandoning the Proposal's on-going asset test.

MBA Is Concerned by the Principal Place of Business Provisions

The final major element of the Proposal would impose a new requirement governing how the System should determine the principal place of business of an insurance company for purposes of membership. The provision would generally establish the principal place of business as “the state in which the institution maintains its home office established in such conformity with the laws under which the institution is organized and from which the institution conducts business operations.”²⁸ Insurance companies would be able to request that a Bank make a determination as to the principal place of business, and the Bank would be required to consider several factors in making such

²⁶ Indeed, the Department of the Treasury expressly referred to the asset tests as a “screen” rather than a minimum asset floor. U.S. Dept. of Treasury, Report to Congress on the Impact of the Gramm-Leach-Bliley Act on Credit to Small Businesses and Farms (January, 2005)

²⁷ Further, such an on-going asset test would facilitate inefficient allocation of capital, particularly in underserved areas.

²⁸ The Proposal at 125.

determination. Finally, a Bank would be required to designate the principal place of business in cases where the insurance company “cannot satisfy” the foregoing. The respective Bank would be required to designate as the principal place of business “the geographic location from which the institution actually conducts the predominant portion of its activities.”²⁹

FHFA is unclear in its rationale for proposing to discard the judgments of state insurance regulators concerning an insurer’s principal place of business. Like the prohibition on captive insurers, this provision reflects the uneven application of FHFA’s regulatory powers to different classes of eligible members, with no clear reason for the disparate treatment. Moreover, insurance regulation is inherently a state endeavor, making FHFA’s attempt to impose what amounts to a parallel domicile regulation inappropriate.

In addition to general concerns with this provision, MBA is concerned that it is ambiguous and could give rise to uneven enforcement. Specifically:

- It is unclear whether the primary criteria under Proposed §1263.19(b) consists of one element or two. Specifically, it is unclear whether the phrase “from which the institution conducts business operations” is:
 - in reference to the applicable provision utilized by the state in which the insurer is organized; or
 - is intended to add an additional analytical element that FHFA would affirmatively evaluate.
- It is also unclear under what criteria FHFA would invoke §1263.19(f) and require a Bank to designate a principal place of business. For instance, what would constitute the inability of an insurer to satisfy the enumerated provisions? In light of the question raised above regarding the “business operations” phrase, what standard would be applied in evaluating the organization of an insurer under state law?

These ambiguities could give rise to uneven enforcement, including potentially applying different standards based on individual states’ insurer regulations. This outcome would be inappropriate and would distort competition by favoring certain state domiciles over others.

In light of these general and specific concerns, MBA recommends FHFA not move forward with this provision.

²⁹ The Proposal at 127.

CONCLUSION

FHFA's Proposal would be a dramatic departure from decades of congressional action and regulatory interpretation. The housing finance market has undergone significant changes since the Act was signed into law, particularly since the financial crisis. Included among these changes is the increasing role played by institutions such as REITs and IMBs in originating and investing in residential mortgages. FHFA can and should adopt a policy of inclusion to ensure the System continues to advance its mission and provide liquidity for residential mortgage lending in the 21st century with stable, committed private capital taking the first loss.

For more information on this topic, please contact Dan McPheeters at (202) 557-2780 or dmcpheters@mba.org.

Sincerely,

A handwritten signature in black ink, appearing to read "D.H. Stevens". The signature is fluid and cursive, with a large, sweeping flourish at the end.

David H. Stevens
President and Chief Executive Officer