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National Association of Federally-Insured Credit Unions

June 22, 2020

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th Street SW
Washington, D.C. 20024

RE: Federal Home Loan Bank Membership Request for Input

Dear Mr. Pollard:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the Request for Input (RFI) issued by the Federal Housing Finance Agency (FHFA) regarding Federal Home Loan Bank (FHLB) membership. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve 120 million consumers with personal and small business financial service products. Many of NAFCU's member credit unions rely on the FHLBs for liquidity purposes in order to fully serve the mortgage and community development needs of their membership. Any expansion of membership to the FHLB System (System) should be limited to those entities which are subject to a regulatory scheme from a prudential regulator and capital requirements. This is the most significant financial factor in maintaining reasonable risk in the System and preserving its benefits for current membership. Further, the FHFA should prohibit the use of conduits as they inject significant serious risk to the system and cannot demonstrate a nexus to the FHLB's public policy mission.

As Congress continues to negotiate another COVID-19 relief package (Phase IV), NAFCU requests the FHFA support revisions to the *Federal Home Loan Bank Act* (FHLB Act) to include credit unions within the definition of "community financial institution" (CFI). This change would make it easier for smaller credit unions to meet the membership eligibility requirements and permit them to obtain long-term advances to fund small businesses, including small farm and agri-businesses, and community development activities.

Expanding Membership to the FHLB System

Of the 6,702 current FHLB members, 6,641 are credit unions, commercial banks, savings associations, savings banks, or insurance companies.[1] Therefore, over 99% of current FHLB members operate under a statutory regime with capital requirements and the examination and oversight of a primary prudential regulator. Of this 99%, only 7% represent insurance companies,

[1] FHLB Membership as of March 31, 2020, Federal Home Loan Bank Member Data, *available at* https://www.fhfa.gov/DataTools/Downloads/Pages/Federal-Home-Loan-Bank-Member-Data.aspx (Last accessed May 27, 2020).

and the number of remaining captive insurance company members following the 2016 rule[2] is in the single digits. Currently, the vast majority of FHLB members are examined depository financial institutions, which provides the System with a significant degree of safety. Regulators' examination reports provide the FHLB with information on the financial condition of a member on an ongoing basis, signaling changes to a member's risk assessment. As stated by the Council of FHLBs in its response this RFI ("FHLB Comments"), when a member is subject to prudential regulation, it reduces credit risk within the System.[3] This, in turn, supports the FHLBs' ability to access global capital markets at attractive rates through all business cycles. Any entity that has a nexus to the FHLB mission and sufficient financial factors should be permitted to join. However, in order to preserve the risk in the System and preserve its benefits for current membership, the most important financial factor must be the presence of capital requirements and a prudential regulator.

In its 2018 analysis and rating report of the System, Standard & Poor's cited as a weakness of the System's that there was a "small, but growing, exposure to nondepository financial institutions."[4] In discussing future business risk, the FHLB of Pittsburgh discussed the potential outcome of legislation and discussions to allow non-banks such as captive insurers and other financial companies to become members. It stated that because these entities are subject to different regulatory requirements and have different risk appetites than current members, their admission "could materially impact the Bank's risk profile and results of financial condition."[5]

It is clear that if real estate investment trusts (REITs) and captive insurance companies have access to the System, they will make significant use of it. Prior to the 2016 final membership rule, captive insurance companies had significant participation in the System. The FHLB of Chicago reported that as of December 31, 2019, three captive insurance company members had a remaining 27.7% of total advances outstanding.[6] Earlier this year, the FHLB of Des Moines reported that a single captive insurance company remains its fourth largest member borrower, representing four percent of total advances.[7] When these entities are granted the benefits of the System, they make substantial use of those benefits to the degree that their participation has raised concerns of concentration risk in credit ratings issued by Standard & Poor's.[8] The participation of these entities cannot be considered nominal and, if granted access to the System, the risks posed by these entities is significant.

Without a prudential regulator and capital requirements to ensure safety and soundness, mortgage REITs have little incentive to balance long term considerations against their primary purpose as for-profit investment vehicles. Mortgage REITs extensively rely on debt to fund operations, which often include high dividend yields for their investors. Mortgage REITs use borrowed funds with

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[2] *See*, 81 Federal Register 3245 (Jan. 20, 2016).
[3] Letter from Council of Federal Home Loan Banks to Mr. Andre D. Galeano, Deputy Director, FHFA, Request for Input (February 2020) (filed Apr. 22, 2020).
[4] Standard & Poor's RatingsDirect (Aug. 1, 2018), Federal Home Loan Banks, page 2.
[5] Federal Home Loan Bank of Pittsburgh (Mar. 10, 2020), 2019 Annual Report on Form 10-K, page 15.
[6] Federal Home Loan Bank of Chicago (Jan. 23, 2020), 2019 Annual Report on Form 10-K, page 19.
[7] Federal Home Loan Band of Des Moines (Mar. 11, 2020), 2019 Annual Report on Form 10-K, page 41.
[8] Standard & Poor's RatingsDirect (July 25, 2016), Federal Home Loan Bank of Des Moines, page 3.

short maturities to purchase long-term mortgages, making them especially susceptible to interest rate risk during some business cycles. Mortgage REITs are highly leveraged and risky investment vehicles that can generate high yield dividends for investors with a high risk appetite.[9] The existing members of the FHLB should not be asked to lend the safety and soundness of their institutions to underwrite affordable and easy access to credit on behalf of these risky vehicles.

These entities have tremendous appetite for consistent and reliable access to the capital markets at a competitive price. However, the price is competitive specifically because of the strength and collective safety and soundness of existing FHLB members. That strength, safety and soundness exist in both perception and reality precisely because these credit unions, commercial banks, savings associations, savings banks, or insurance companies are regularly examined by primary prudential regulators.

Credit unions are subject to a significant supervisory regime by the National Credit Union Administration (NCUA), including capital requirements and regular examination for safety and soundness in accordance with NCUA's regulations. Banks are subject to similar requirements. As stated in the FHLB Comments, any new members given access to the System must be subject to a supervisory regime of a prudential regulator *at least* equivalent to that applicable to all currently-eligible members. For example, nondepository institutions that have a prudential regulator, such as financial companies designated for Federal Reserve supervision by the Financial Stability Oversight Council or independent mortgage bankers sufficiently supervised by state authorities, would pose significantly less risk than other nondepository financial companies. A change of this nature would require Congressional action as these entities cannot currently access membership under the current statute.[10] However, any expansion of FHLB membership that falls short of this requirement threatens the low-cost debt franchise for existing members, which is critical to the function and stability of the American mortgage system.

This reliance on supervisory regimes overseen by prudential regulators has benefits beyond controlling an applicant's initial risk to the System. The FHFA states that the FHLBs have improperly applied regulatory provisions on membership eligibility. The solution to this difficulty is not to create additional, parallel frameworks for admission where riskier, nondepository financial institutions are permitted to provide less or significantly different information than depository financial institution members. To the extent possible, all entities able to become members should be subject to similar requirements. This will reduce errors in reviewing membership applications, prevent ineligible applicants from entering the system and improve the FHLBs' ability to identify risk trends in the System across all members.

Permitting the Use of Conduits

In its 2016 final rule, the FHFA found that REITs and other noneligible entities were evading the legal requirements for admission to the FHLB System by establishing captive insurance companies

[9] *Mortgage REITs – High Yield but High Risk*, James Shanahan, CFA, Edward Jones (Apr. 13, 2020) *available at* https://www.edwardjones.com/images/mortgage-reits-high-yield-but-high-risk.pdf (last accessed May 29, 2020).
[10] *See*, 12 U.S.C. § 1424(a).

specifically to serve as a conduit for FHLB funds.[11] The advances taken by these captives were "grossly disproportionate" to the amount of actual insurance business these captives were conducting, making it clear that the advances were actually flowing to the ineligible parent organizations.[12] The financial condition of these captive insurance companies reported to the FHLB did not reflect the actual captive insurance companies' condition, instead, it reflected the financial condition of their ineligible, nonmember parent company.[13]

Bona fide insurance companies are included in FHLB membership because of their significance in the housing finance system and because they are regulated entities with capitalization requirements and prudential regulators – therefore the risk posed by insurance companies is categorically low, protecting the strength of the System and ensuring the benefits of inexpensive liquidity. However, where a captive insurance company's participation in the System is significantly disproportionate to its actual insurance operations, this no longer holds true. To accurately assess the risk posed by these captives, the FHLB assesses the activities and financial condition of the ineligible nonmember parent entity that is actually using the capital and assuring its repayment.[14] These entities are ineligible for membership precisely because they are not subject to similar controls. A captive entity serving as conduit for ineligible entities introduces risk into the System that may be difficult to accurately assess, monitor or mitigate, ultimately putting the benefits of FHLB members at risk for existing members.

Further, a captive insurance company that was created to permit its ineligible parent company to access affordable capital can hardly be said to have a nexus to the housing or community development mission of the System. Often, these captives offer very narrow mortgage-related insurance policies, such as terrorism or limited mortgage impairment coverage, to serve as a fig-leaf nexus to the FHLBs' mission.[15] However, as the FHFA stated in its 2016 rule, the actual business conducted by these organizations is small, and the true mission of the organization was to permit the flow of capital to an ineligible parent company.[16] While the parent company may or may not be able to demonstrate such a nexus, it is clear that the sole mission of these captives is to provide its parent company with access to capital at attractive rates, and any claimed nexus to the mission of the FHLBs is fraudulent.

The FHFA stated that since the 2016 rule, it has observed ineligible entities attempting, again, to circumvent membership rules using nondepository CDFIs and special purpose banks. The use of conduits must be prevented to protect the System, not only with regard to safety and soundness, but also with regard to its housing finance and community development mission. However, protecting this mission should not mean creating additional hoops for existing members to jump through. To protect the safety and soundness and the mission of the System, member entities that

[11] 81 Federal Register at 3254-3255.
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Using Captives to Access Federal Home Loan Banking System Funding*, Denise Graham, Marsh (Mar. 2014) accessible at https://www.marsh.com/pr/en/insights/research/using-captives-to-access-federal-home-loan-banking-system-funding.html (last accessed May 29, 2020).
[16] 81 Federal Register at 3254-3255.

are susceptible to use as conduits should not be permitted to take advances disproportionate to the actual business conducted by the entities. Further, advances should not be based on the strength of the financial condition of their parent entity. This approach would not unduly burden the vast majority of FHLB membership which is operating in good faith.

The practice of creating sham entities to access FHLB membership and inexpensive capital exposes the System to significant risk. This risk is out of line with that posed by the existing membership, threatening the core benefit of the System: access to capital at a price based on the strength of America's depository institutions. There is no data in the RFI or elsewhere to indicate that expanding membership to including REITs, captive insurance companies or conduits generally provides any benefit to the System or its current members to offset this risk. As such, the use of conduits should be explicitly prohibited.

Credit Unions Are Community Financial Institutions

Under the FHLB Act, a CFI is defined as an institution with deposits insured under the *Federal Deposit Insurance Act* and total assets less than the CFI asset cap, which is currently $1.224 billion. Unfortunately, this formulation entirely excludes credit unions which are insured by NCUA. NAFCU requests the FHFA support legislative efforts to include credit unions as CFIs under the FHLB Act.

Structurally, credit unions are bound to a mandate to serve their communities because they are not-for-profit, member-owned financial cooperatives. They may only serve their defined fields of membership, a term that encapsulates the legal requirement for credit unions and the members they serve to share a common bond. Due to this unique structure and the significant legal limitations placed on credit unions to ensure this mission is adhered to, all credit unions are inherently community financial institutions.

Including credit unions in the definition of CFI would allow more credit unions to make use of the exception to the membership requirement to have 10 percent of total assets in residential mortgages.[17] There are currently 1,535 credit union members of the FHLB.[18] According to the most recent data from NCUA, there are 4,973 credit unions with assets under $1.224 billion. Of these, 2,279 credit unions have less than 10% of their total assets in mortgage loans and cannot currently qualify for membership without use of the exception. Including these credit unions in the CFI definition would increase FHLB membership by safe and sound organizations that share the FHLB's mission of community development. Further, under the FHLB Act, a CFI can pledge small business, small farm, small agri-business, and community development loans to a FHLB as expanded options of collateral for advances. Including credit unions in the definition of CFI and raising the threshold to $10 billion would provide greater lending capacity for a number of credit unions and safely increase demand for advances.

[17] 12 C.F.R. § 1236.6(b).
[18] FHLB Membership as of March 31, 2020, Federal Home Loan Bank Member Data, *available at* https://www.fhfa.gov/DataTools/Downloads/Pages/Federal-Home-Loan-Bank-Member-Data.aspx (Last accessed May 27, 2020).

While all credit unions should be included in the definition of CFIs, if an asset cap is necessary, it should be raised. According to the most recent data from NCUA, there are 5,226 credit unions with assets under $10 billion. These credit unions are currently unable to enjoy the benefits extended to community financial institutions in the FHLB Act and its implementing regulations. If the cap were raised to $10 billion, this would enable more credit unions to access liquidity to provide more communities across America with the finest lending products available in the market. By making this change, membership to the FHLBs can be expanded safely and soundly to a significant number of insured credit unions who are overseen by a primary prudential regulator under a regulatory scheme and, by their very nature, are inherently committed to the FHLB mission of community development.

NAFCU has urged[19] Congress to expand the CFI definition in the FHLB Act to include credit unions and to raise the asset threshold to $10 billion in any further COVID-19 relief legislation. NAFCU would welcome the support of the FHFA in this effort to correct the exclusion of credit unions from this statutory definition and to raise the threshold. These changes will ensure that the benefits of the FHLB System are fairly and appropriately extended to as many members as possible.

Conclusion

NAFCU appreciates the opportunity to provide input in response to the FHFA's RFI. Ultimately, in order to protect the benefits of the system for its current members, the FHFA should require that any new types of members be subject to a statutory regime of capital requirements and examined by a primary prudential regulator, in addition to being able to demonstrate a nexus to the FHLBs' public policy mission. Further, the FHFA should absolutely prohibit the use of conduits for the safety of the System. If you have any question or concerns, please do not hesitate to contact me at (703) 842-2272 or elaberge@nafcu.org.

Sincerely,

E Young LaBerge

Elizabeth M. Young LaBerge
Senior Regulatory Counsel

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[19] Letter from Dan Berger, President/CEO, NAFCU, to Congressional Leadership (April 7, 2020), *available at* https://www.nafcu.org/system/files/files/4-7-20%20Letter%20to%20House%20and%20Senate%20Leadership%20on%20COVID-19%20Phase%20IV%20Relief.pdf (last accessed June 3, 2020).