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VIA ELECTRONIC SUBMISSION ON WWW.FHFA.GOV

Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590–AA39
Federal Housing Finance Agency
400 Seventh Street SW, Eighth Floor
Washington, D.C. 20024

Re: Notice of Proposed Rulemaking and Request for Comments – Members of Federal Home Loan Banks (RIN 2590–AA39)

Dear Mr. Pollard:

The Federal Housing Finance Agency ("FHFA") has requested comments on its notice of proposed rulemaking ("NPRM") regarding members of the Federal Home Loan Banks ("FHLBanks").[1] The NPRM states that it seeks to address issues related to the membership requirements and the FHLBanks' housing finance mission—in doing so, the FHFA proposes to revise several of its regulations regarding membership eligibility. On behalf of the Council of FHLBanks, a trade association whose members are the twelve FHLBanks, I am submitting this comment on the NPRM.

The NPRM, if finalized, will fundamentally alter the FHLBanks' relationship with their members and impair the FHLBank System's ability to advance its congressionally-mandated mission of providing liquidity to support housing finance markets and the U.S. financial markets generally. The FHFA seeks to adopt new continuing membership requirements and proposes significant changes to FHLBank membership eligibility that cut to the core of the FHLBanks' statutory direction, history, and practice. However, the FHFA has shown no compelling need for such an extensive change. Further, the FHFA's NPRM does not explore less invasive options for correcting the problems that the FHFA believes the proposals will address. Additionally, the NPRM asserts without evidence or empirical data that some insurance company members are not supporting the FHLBank System's housing goals or may pose some risk to the FHLBank System. However, the evidence is to the contrary, as insurance companies (including captive insurance companies) have been members of the FHLBank System in good standing for many years without any indication that they have caused problems for the FHLBank System.

The NPRM goes beyond interpreting and implementing the explicit language and intent of the Federal Home Loan Bank Act ("FHLBA"): in some areas, the FHFA's proposals directly contravene the intent of Congress and run contrary to subsequent acts of Congress that have

[1] 79 Fed. Reg. 54848 (Sept. 12, 2014) [hereinafter NPRM].

served to broaden the scope of the FHLBanks' mission and membership. In addition to exceeding its statutory authority and attempting to amend the FHLBA through regulation, many of the proposals will be harmful to the FHLBanks and their members. The FHFA's attempt to quantify general principles and remove FHLBank discretion will serve to stifle membership and inappropriately constrain the FHLBanks in performing their statutorily mandated mission.[2] The NPRM does not adequately address the costs that will be borne by the FHLBanks, their members, and ultimately housing market participants—nor does it weigh these costs against the intended benefits of this sweeping regulatory overhaul.

I. The FHLBanks' Mission to Provide Liquidity to the Housing Finance Markets Is Supported by a Diverse and Robust Membership

A. Providing Liquidity to Members Is a Primary 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."[3] This is not a new or novel mission. The FHLBank System originated from the need to provide liquidity in the housing finance markets during the 1930s crisis.[4] In the 1980s, the Federal Home Loan Bank Board ("FHLBB") looked to the FHLBanks as a source of liquidity for troubled institutions. The FHLBank System's role in providing liquidity has only expanded. In 2008, Congress formalized the FHFA's role in ensuring that the FHLBanks are able to "foster liquid, efficient, competitive, and resilient national housing finance markets" and explicitly recognized the FHLBanks' mission of providing liquidity to members without limiting that purpose to housing finance, highlighting a dual mission of "providing liquidity to members" and supporting "affordable housing and community development."[5]

The FHLBanks' ability to fulfill this statutory mandate to provide liquidity to members was clearly demonstrated during the recent financial crisis, in which the FHLBanks provided liquidity to their members during the early stages of that crisis. Imposing additional regulatory restrictions on membership beyond those currently in place will impair the FHLBanks' ability to fulfill this important statutory purpose in the future and introduces a possible future systemic risk to the U.S. economy.

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[2] *See, e.g.*, Jody Shenn, *Backlash Brews as Banks and REITs Oppose FHLB Rule Change*, Bloomberg (Sept. 17, 2014 10:18 A.M.), http://www.bloomberg.com/news/2014-09-17/backlash-brews-as-banks-and-reits-oppose-fhlb-rule-change.html (stating that the FHFA's "proposal represents a departure from the long standing FHLB membership rules that have helped promote housing, jobs and economic development" (quoting the American Council of Life Insurers)).

[3] FHFA, *FHFA Strategic Plan: Fiscal Years 2015–2019*, at 10 (as released for public input on Aug. 15, 2014).

[4] *Id.*; Dirk S. Adams & Rodney R. Peck, *The Federal Home Loan Banks and the Home Finance System*, 43 Bus. L. R. 833, 836 (1988) ("The effect of the FHLB Act and HOLA was to help meet the liquidity crisis being suffered by thrifts during the Depression.").

[5] The Housing and Economic Recovery Act of 2008 ("HERA"), Pub. L. 110-289 § 1201, 122 Stat. 2654 (2008), codified at 12 U.S.C. § 4513.

Congress has continuously expanded the FHLBanks' mission beyond a narrow housing finance authority. In 1999 and again in 2008, Congress expanded the types of eligible collateral that community banks could pledge to secure advances.[6] For community financial institutions ("CFIs"), Congress expanded the FHLBanks' authority to take collateral including "secured loans for small business, agriculture, or community development activities or securities representing a whole interest in such secured loans."[7] After these cumulative actions by Congress, there are few, if any, credible legal arguments that the mission of the FHLBanks remains confined exclusively to supporting housing finance.

Moreover, the FHFA and its predecessor agencies have consistently recognized that the FHLBanks' mission includes more than just housing finance. In 2000, the Federal Housing Finance Board ("FHFB") promulgated a regulation enumerating the specific activities that qualify as "core mission activities."[8] The FHFB explained that the intent of this provision is to focus the FHLBanks' strategic business plans on the activities that the FHFB has determined are most central to the fulfillment of the FHLBanks' statutory mission.[9] These core mission activities include:

- Intermediary derivative contracts;
- Debt or equity investments that primarily benefit households having targeted income levels or areas targeted for redevelopment, and that support housing, economic development, community services, permanent jobs, or area revitalization or stabilization;
- Investments in a Small Business Investment Company if one or more members or associates also makes a material investment in the same activity;
- SBA guaranteed debentures; and
- SBA guaranteed short-term tranches of SBIC securities.

In 2009, the FHFA determined that federally insured student loans can be used to support FHLBank advances.[10] And in 2010 FHFA issued a regulation providing that CFIs may pledge loans made for community development purposes as collateral for advances.[11] Thus, it is clear that both Congress and the relevant regulatory agencies have recognized that the mission of the FHLBank System goes beyond simply providing liquidity for housing finance. Restricting

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[6] The Gramm-Leach-Bliley Act of 1999 ("GLBA"), Pub. L. 106-102 § 604, 113 Stat. 1338 (1999), codified at 12 U.S.C. § 1430; HERA § 1206, 12 U.S.C. § 1424(a)(1).

[7] *Id.*

[8] 65 Fed. Reg. 43969 (July 17, 2000).

[9] *Id.*

[10] FHFA, 2009-RI-01 (June 4, 2009).

[11] 75 Fed. Reg. 76617 (Dec. 9, 2010).

membership as proposed in the NPRM will significantly hamper the ability of an FHLBank to accomplish these other important missions of the FHLBank System.

B. Providing Liquidity to Members through Advances Supports the FHLBanks' Expanded Statutory Housing Mission and the U.S. Financial System Generally

General liquidity of the U.S. financial system is a "primary driver" of FHLBank advances.[12] Helping ensure member liquidity is a fundamental aspect of the FHLBanks' core mission, highlighted by the FHFA's own strategic plan.[13] Further, advances—even those made for Basel III compliance[14]—are "core housing mission assets" and are critical to the FHLBank System's mission.[15] Tightening membership requirements and narrowing the eligibility for certain institutions would be counterproductive to this important aspect of the FHLBanks' mission.

The prelude to the 2008 enactment of HERA shows why Congress shifted the focus to providing liquidity to member institutions. Former Acting Director Edward DeMarco has stated that "[w]ith the onset of the financial crisis in late 2007, the FHLBanks became a key provider of liquidity . . . . [t]he FHLBanks demonstrated they were a reliable source of credit to their members, and that they could meet member liquidity needs safely and soundly."[16]

The FHFA Office of Inspector General ("OIG"), in its 2014 Report, has noted the FHFA's approval of a member using advances purely for liquidity purposes, stating that "FHFA officials emphasized that FHLBank advances for the purpose of meeting recent liquidity requirements are legal and not inconsistent with the FHLBank System's mission."[17] Moreover, in its 2015–2019 Strategic Plan, the FHFA itself highlights "ensur[ing] liquidity, stability, and access in housing finance" as one of its strategic goals.[18] The FHFA states that it "will work to ensure that the FHLBanks continue to fulfill their statutory mission of providing liquidity to their

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[12] FHFA-OIG, *Recent Trends in Federal Home Loan Bank Advances to JPMorgan Chase and Other Large Banks*, EVL-2014-006, 18 (Apr. 16, 2014) [hereinafter FHFA-OIG Report].

[13] FHFA Strategic Plan: Fiscal Years 2015–2019.

[14] "Basel III" refers to bank liquidity standards established by the international Basel Committee on Bank Supervision, and implemented in the U.S. through regulations issued by the Federal banking agencies earlier this year. Under these regulations, banks must increase their holdings of high quality liquid assets ("HQLAs") to improve their ability to withstand anticipated cash outflows for a thirty-day period. The use of FHLBank advances, rather than short term funding instruments, is an important tool that can be used by members to meet the required Basel III liquidity ratios.

[15] FHFA-OIG Report at 18 ("The surge in advances to large members may serve to offset some of the [FHLBank] System's non-core mission assets."); *see also* 12 C.F.R. § 1265.3(a) (stating that "advances" are "core mission activities").

[16] Edward J. DeMarco, Acting Director, Fed. Hous. Fin. Agency, The Future Role of Federal Home Loan Banks in Housing Finance (May 8, 2012).

[17] FHFA-OIG Report at ii.

[18] FHFA Strategic Plan at 9.

members."[19] The NPRM provides no discussion of the impact that its proposals will have on the FHFA's statutory obligation to ensure that the FHLBanks can provide liquidity to their members or the systemic risks to the U.S. economy if the FHFA would act to prevent the FHLBanks from making such advances to its members.

The Federal Reserve Board ("FRB") has also noted the importance of the FHLBanks to the liquidity of depository financial institutions. In a 2008 study, the Federal Reserve Bank of New York found that during the financial crisis the FHLBank System was "by far, the largest lender to U.S. depository institutions."[20] A Fitch Ratings Special Report highlights that the FHLBanks were instrumental in supporting insurance companies during this troubled period. The FHLBanks "provided needed liquidity to the banking and insurance industry during the financial crisis, allowing them to turn their somewhat illiquid mortgage portfolio into funds that could be used to finance operations without forced asset liquidation."[21] The FHLBank System thus plays an important role in the liquidity of U.S. financial systems generally.

C. Sustaining and Growing Membership Is a Crucial Function of the FHLBank System

Supporting members supports the FHLBank System. The FHLBank System is a voluntary system that operates not through governmental fiats proscribing action, but by providing financial incentives to encourage voluntary behavior that Congress has deemed worthy of support. Breadth of membership and participation are key components of the FHLBanks that allow them to provide the products and services to advance the FHLBank System's housing market liquidity and affordable housing goals.[22] In order to incentivize as many members as possible to engage in such desired activity, in 1989 Congress amended FHLBA to broaden the

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[19] *Id.* at 10.

[20] Adam B. Ashcraft, et al., Federal Reserve Bank of New York, Staff Report No. 357 28–29 (Nov. 2008).

[21] Fitch Ratings, The Federal Home Loan Bank System: Its Role in the Life Insurance Industry, Special Report 5 (June 12, 2013) [hereinafter Fitch Report]. The Fitch Report goes on to state:

> During the financial crisis, insurance companies increased use of FHLB advances as a quick source of funding to boost their liquidity. FHLB advances to insurance companies increased 91% between 2007 and 2008, a much larger percentage increase than the 35% rise for non-insurers over the 2006–2008 period. . . . In the years since the financial crisis, insurance industry recognition of the FHLB funding availability seems to have led to increased membership and uses of advances.

Id.

[22] Statement of Andrew J. Jetter President and CEO Federal Home Loan Bank of Topeka, Before the Senate Comm. on Banking, Hous. & Urban Affairs Subcomm. on Securities, Ins. & Inv. (July 23, 2013) ("The FHLBanks have been able to successfully fulfill their mission as a result of several unique characteristics: their cooperative structure; a scalable, self-capitalizing, operating model; broad participation by a diverse membership; and dependable access to a deep, liquid market for FHLBank debt.").

scope of the FHLBanks' incidental powers.[23] The legislative history of the FIRREA amendments highlights that:

> The amendment is intended to ensure that the banks may provide a variety of products and services. This variety makes membership in the banks appealing to eligible institutions. *By sustaining members, the banks are better able to meet the financial obligations that the act imposes on them.*[24]

The FHFA-OIG has noted the benefits in increased FHLBank advances, including "higher interest income and an increased focus on regulatory-defined core housing mission assets."[25] In its 2014 Report, the FHFA-OIG stated that:

> The interest income generated by surging advances could help stabilize the finances of individual FHLBanks and, potentially, the [FHLBank] System as a whole. FHLBanks also may pay both cash and stock dividends to their large and small members alike based on quarterly or annual profits. Moreover, increased interest income generated by advances would cause the FHLBanks to contribute more to their Affordable Housing Programs ("AHP"), which receive 10% of each FHLBank's net income each year.[26]

The FHLBank System benefits from a diverse and robust membership. Advances not only support the liquidity of members (allowing them to engage in the housing finance markets), they support the FHLBanks' affordable housing and community development mission.

II. The Proposed Ongoing Requirements Contravene the FHLBA and Would Harm the FHLBank System

The NPRM proposes to fundamentally alter the long-standing practices and prior requirements placed on members of FHLBanks by requiring "each member to comply on an ongoing basis, rather than on a one-time basis as at present" with the membership eligibility requirements.[27] Further, the NPRM proposes to create a quantitative test, of "at least one percent" to measure the requirement that FHLBank members make long-term home mortgage loans.[28] The NPRM notes that its proposal is needed because an applicant could cease making home mortgage loans once it became a member of the FHLBank System.[29] The FHFA has

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[23] Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L 101-73 § 709, 103 Stat. 183.

[24] 135 Cong. Rec. H4994 (daily ed. Aug. 3, 1989) (remarks of Congressman Garcia).

[25] FHFA-OIG Report at 23.

[26] *Id.* at 17.

[27] NPRM at 54848.

[28] *Id.* at 54851.

[29] *Id.* at 54848; *see also id.* at 54853 (noting that the "FHFA has found no evidence that this problem is widespread").

provided no data indicating that this hypothetical issue has created any actual systemic issues, but merely asserts the possibility of an issue as grounds for a new and more restrictive regulatory scheme. The FHFA asserts its authority to impose this new scheme based on two areas of the FHLBA: construction of the phrase "eligible to become a member,"[30] and an extension of an exception to the general eligibility requirements for *de novo* depository institutions.[31] However, as will be demonstrated below, neither basis withstands closer analysis.

A. The FHFA's Interpretation of Section 4 is Contrary to the Plain Meaning of Section 4 of the FHLBA

The FHFA's proposal to make its membership eligibility requirements mandatory on an ongoing basis, tied to rigid quantitative tests, has no foundation in the FHLBA or its legislative history. The language of the FHLBA cannot be construed, and has never been construed, so as to require or allow ongoing application of the threshold eligibility requirements.

The FHFA cannot insert an ongoing quantitative requirement into the FHLBA without in effect amending the statute. Nothing in the legislative history of the FHLBA or its subsequent amendments supports the FHFA's construction of the membership eligibility requirements as ongoing tests rather than point-in-time entry requirements. Instead, the NPRM makes inferential leaps from inapposite provisions of the FHLBA[32] and cites to internal memoranda to support its position.[33]

The membership requirements "under the statute [are] a one-time screen, rather than an ongoing requirement."[34] The FHFA's attempt to stretch the FHLBA's language "eligible to become a member" into an ongoing test is not a permissible construction of the FHLBA.[35] Nothing in this statutory language implies that the membership eligibility requirements must be reviewed on an ongoing basis. Rather, the statute is structured as a point-in-time threshold analysis. Since the statute as a whole provides tools to ensure that the FHLBanks maintain a nexus with housing,[36] the FHFA cannot turn eligibility requirements into an ongoing regulatory scheme.

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[30] *See* 12 U.S.C. § 1424.

[31] *See id.* § 1430.

[32] NPRM at 54852 (citing 12 U.S.C. § 1424(a)(3), which allows *de novo* depository institutions to meet the eligibility requirements within one year, since the data needed to show a commitment to housing finance would necessarily not be available until that time).

[33] *Id.* at 54853.

[34] *See* U.S. Dept. of Treasury, Report to the Congress on the Impact of the Gramm-Leach-Bliley Act on Credit to Small Businesses and Farms (Jan. 2005) (discussing the requirements to "*become* a member of an FHLBank" and noting that the requirements need not be *"maintained"*) (emphasis added).

[35] *See infra* Section IV (discussing the Administrative Procedure Act's restrictions on the construction of authorizing statutes).

[36] *See infra* Section II.B. (discussing the FHLBA's provisions regarding eligible collateral).

The FHFA relies on a minor exception to support major changes. Citing to the *de novo* depository institution rule, the FHFA highlights an exception to the point-in-time nature of the membership requirements that proves the rule.[37] The FHLBA creates an extension of the point-in-time membership eligibility requirements to allow for new institutions that will be eligible, but do not yet have the data to show it. This is not, as the FHFA argues, evidence that supports ongoing tests; rather the *de novo* depository institution exception highlights Congress's clear intent to view the membership eligibility requirements at a point-in-time, with limited exceptions.

B. The FHFA's Proposal Provides De Minimis *Benefit to the FHLBank System*

The FHFA's initial research in its 2010 advanced notice of proposed rulemaking ("ANPR") showed that the vast majority (about 98%) of FHLBank members currently comply with the 10% requirement and another 1% have more than 9% of their assets in mortgages.[38] Four years later, the numbers presented by the FHFA in its NPRM remain the same.[39] This data, cited to show the minimal impact of the proposed changes, instead shows a lack of any need for change at all.

The presumptive compliance and rebuttable approaches of the current regulations have served the FHLBanks well for over a decade. The FHLBanks have the authority to approve membership and should continue to have the statutorily prescribed authority to use their discretion in resolving membership issues that arise in their unique mix of members. Additionally, the FHLBanks' housing finance and liquidity mission is supported by several existing regulatory requirements and limits. The Residential Housing Finance Asset ("RHFA") test[40] assists in achieving the FHLBanks' housing finance and liquidity mission by limiting the amount of long-term advances members are able to obtain to the amount of total residential housing long-term assets they currently hold. Members are already subject to an ongoing home financing compliance requirement. Currently, members are selected randomly every two years by the FHFA to complete the Community Support Statement. The Community Support

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[37] *See* NPRM at 54852 (noting that 12 U.S.C. § 1424(a) "permits a newly chartered insured depository institution to become a Bank member without meeting the '10 percent' requirement, so long as it subsequently demonstrates that it has satisfied that requirement within one year after commencing its business operations"). The NPRM argues that this *exception* to the point-in-time membership criteria provides a basis for completely redrafting the membership requirements of the FHLBA.

[38] 75 Fed. Reg. 81145, 81151 [hereinafter ANPR].

[39] NPRM at 54859. Indeed, there is even less need for the FHFA's proposals today than when the ANPR was issued. The NPRM notes that 99.2% of commercial banks and 98.8% of credit unions would comply with the proposed 1% requirement. *See id.* 83.4% of insurance company members would also comply. *See id.* Even though the FHFA's proposals are not needed by the vast majority of FHLBank members, the operation of these mechanical rules has the potential to result in the FHLBank System losing billions of dollars in advances and collateral. *See infra* Section II.C.1. The NPRM does not weigh the high cost of its proposals against the minuscule benefit, if any, the proposed rules might provide.

[40] 12 C.F.R. § 1266.3(b)(1).

Statement requires members to certify that they actively support the first-time homebuyer market in order to access FHLBank long-term advances and CICA funding.[41]

Further, members are subject to an "ongoing" requirement to support housing finance and liquidity every time they take an advance. Whenever any member seeks an advance from its FHLBank, it must provide "eligible collateral" related to housing.[42] Eligible collateral is determined by statute, representing a mechanism put in place by Congress to ensure that advances were appropriate for the FHLBank System's goals. Between 2010 and 2012, 97% of the FHLBank System's advances were secured by eligible collateral related to housing.[43] This requirement serves as a self-enforcing mechanism that ensures adherence to the FHLBanks' housing finance and liquidity mission.

Moreover, it provides a flexible and adaptable means of ensuring the appropriateness of advances with minimal burden on the FHLBanks. In fact, the Congressional Record indicates this was precisely the intent of Congress. The House Conference Report from FIRREA states that "[m]eeting the specific asset threshold test does not raise any presumption with respect to whether the applicant's policies are consistent with sound economic home financing. The member's access to advances, however, would be limited by that institution's demonstrated commitment to housing as provided under the advance section."[44] Congress intended the membership requirements to be analyzed at the time of membership approval, but expected a member's access to advances, through eligible collateral limitations, to be the mechanism by which members accessing FHLBank advances would continue to support housing finance. Accordingly, while Congress did not intend "to allow institutions to abandon their commitment to the residential mortgage markets after having been admitted to membership in a cooperative,"[45] it provided other mechanisms—rather than ongoing balance sheet tests—to ensure that members support the FHLBank System's housing finance and liquidity mission.

The FHLBank System is designed, and operates most efficiently, by providing an easy-to-use liquidity mechanism for its members who hold eligible collateral—liquidity that the other financial markets may not always support, especially in times of financial distress such as discussed above. The above-referenced tools ensure member liquidity without impairing the FHLBanks' ability to work with members on a case-by-case basis or forcing members into highly rigid and potentially detrimental asset structures.

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[41] *See, e.g.*, *id.* § 1290.3 (discussing FHFA's review of community support statements).

[42] *See id.* § 1430(a)(3).

[43] FHFA, Report on Collateral Pledged to Federal Home Loan Banks 5 (Sept. 2013).

[44] H.R. Conf. Rep. 101-222, 423–24, *reprinted in* 1989 U.S.C.C.A.N. 432, 463–64.

[45] NPRM at 54852.

C. Foreseen and Unforeseen Harm to the FHLBanks

1. Foreseeable Harms: Volatility and Reduced Ability to Fulfill the FHLBanks' Mission

i. The FHFA's proposals would stifle FHLBank membership

If members are automatically terminated for failing to comply with the rules proposed by the FHFA, as the NPRM would mandate,[46] the capital stock bases of the FHLBanks would become more volatile and less stable as stock is redeemed or repurchased. This could impact the capital adequacy of the FHLBanks, as well as the stability of the FHLBank System and its effectiveness in meeting national liquidity in housing finance and affordable housing objectives.[47]

Through its proposed ongoing requirements, the FHFA would be effectively mandating a permanent minimum asset allocation for each member, applicable throughout every conceivable economic cycle, regardless of a member's use of FHLBank services. This creates a disincentive for some members to join the FHLBank System to support the level of housing finance they deem appropriate for their institution, and is thus contrary to the expressed will of Congress to provide financial incentives to institutions which hold assets that qualify as eligible collateral. Additionally, making the 10% requirement ongoing would greatly diminish the reliability of the FHLBanks as a general liquidity source—potentially destabilizing the FHLBank System's membership base during a crucial period of recovery. The ramifications of members failing the test at some point in time, but then later satisfying the requirement, would also disrupt the workings of the FHLBanks because institutions might be required to terminate their memberships and redeem their capital stock only to later re-qualify and possibly rejoin their FHLBank.

The FHFA's proposals also present regulatory hurdles for the FHLBanks. The NPRM tasks the FHLBanks, which are not federal regulators, to aggregate and on asset composition of each of their members on an annual basis. However, the NPRM does not specify the mechanisms by which the FHLBanks could obtain this information—much of which may be restricted from disclosure by the members' regulators; this could possibly create a conflict for the member with its prudential regulator.[48] The FHFA itself notes difficulty in compiling a complete picture of members' finances.[49] It is likely that such information would only be made available to the FHLBanks in this new role after a statutory change.

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[46] *Id.* at 54867.

[47] *See* Comments of the FHLBanks, RIN 2590-AA37 at 3–4 (Mar. 23, 2011).

[48] The NPRM suggests that these reports are "readily available" to the FHLBanks, NPRM at 54862, thus sidestepping any discussion of the complexities of the proposed regulatory scheme.

[49] *See* NPRM at 54859–60.

It is self-evident that the NPRM's requirement for an ongoing test of membership would negatively impact the FHLBank membership. For example, application of the FHFA's proposed ongoing 10% test would have caused thirty non-CFI bank and forty-one credit union members to have failed the test at least once since 2008.[50] Based on second quarter 2014 data provided by all FHLBanks, the FHFA's proposal would have reduced the total advance balances by $18.1 billion and total available collateral would have been reduced by $62.6 billion.

Under the FHFA's quantified "makes home mortgage loans" test—examined at the 1% requirement, the lowest level considered by FHFA—22 bank, 10 credit union, 21 insurance company (excluding captive insurance companies), and 3 non-depository community development financial institution ("CDFI") members would have failed the test. Based on second quarter 2014 data provided by all FHLBanks, total advance balances would be reduced by $10 billion and the total available collateral would have been reduced by $12.2 billion.

ii. The FHFA's proposals would be particularly harmful to CFIs and CDFIs

The proposed rule would be particularly harmful to two categories of FHLBank membership comprised of small financial institutions—CFIs and CDFIs—in spite of the fact that Congress has repeatedly acted to expand the opportunities for the FHLBanks to serve these members.[51] The FHFA's proposal would require every CFI member to hold on its balance sheet a specified amount of mortgage assets as a condition for continued membership, in spite of the fact that Congress has authorized and encouraged the FHLBanks to make advances to CFIs to support funding for expanded activities in other asset categories involving small businesses, small farms, small agri-businesses, and community development activities.

In addition to including CFIs as FHLBank members, Congress has also expanded FHLBank membership to include CDFIs. Through HERA, Congress amended Section 4(a)(1) of the FHLBA to expand FHLBank membership eligibility to include CDFIs.[52] In 2010, the FHFA issued a final rule implementing this provision of HERA to help facilitate CDFI membership in the FHLBanks.[53]

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[50] Data collected from FHLBanks, as of December 21, 2013, based on a three-year-end average.

[51] The GLBA expanded FHLBank membership to include CFIs as a new class of FHLBank member. GLBA § 601, 12 U.S.C. § 1422(10). The GLBA also specifically exempted CFIs from the requirement that insured depository institutions have at least 10% of their total assets in residential mortgage loans in order to become an FHLBank member. *Id.* § 605, 12 U.S.C. 1424. In addition, the GLBA amended Section 10 (a)(2) of the FHLBA to provide that long-term FHLBank advances may be made for the purpose of providing funds to CFIs for small businesses, small farms, and small agri-businesses; and authorized the FHLBanks to accept as collateral for advances to CFIs secured loans for small business, agriculture, or securities representing a whole interest in such secured loans. *Id.* § 604, 12 U.S.C. § 1430.

[52] HERA § 1206, 12 U.S.C. § 1424(a)(1).

[53] 76 Fed. Reg. 678 (Jan. 5, 2010).

Imposing a continuous membership test on CDFIs and requiring them to meet a quantified "makes home mortgage loans" test by maintaining at least 1% of total assets in narrowly defined housing related assets could be especially difficult for some CDFIs. The specific assets that CDFIs hold in portfolio may not meet the strict definition of the 1% test, since many CDFIs may hold only a part of a "participation loan" and may hold business loans and loans to developers of affordable housing units that would not count toward the 1% test. Imposing new onerous membership requirements on CDFIs would be in conflict with Congress' stated intent to make CDFIs eligible for FHLBank membership as well as the FHFA's final rule implementing this statutory provision.

2. Unforeseeable Harms, Uncertainty, and Instability

The proposed ongoing requirements would also introduce an element of uncertainty and instability to FHLBank membership. Under the proposed rules, members would have no certainty regarding their ability to meet the ongoing tests and therefore maintain their access to FHLBank liquidity and funding products, particularly in times of financial stress, such as the recent financial crisis. For example, in periods of mortgage valuation instability, members could not be assured of maintaining at least 10% of their assets in mortgages. A member's asset mix could change in response to instability, according to the member's strategy, or other reasons, including supervisory direction from its prudential regulator. The FHLBanks would be viewed by both existing members and potential members as a far less reliable source of advances, potentially chilling new membership applications and driving away qualified current members.

The uncertainty in membership status created by imposing ongoing requirements is one reason such requirements should not be implemented. The ramifications of members potentially falling out of compliance with an ongoing requirement are significant if the noncompliance leads to a member's termination. The NPRM does not discuss whether members terminated under the mandatory provision would be subject to the five-year prohibition on readmission to an FHLBank or whether they could be re-qualified as soon as they were able to show themselves back in compliance.[54] Further, the NPRM does not discuss the effect of mandatory termination under the stock redemption periods,[55] leaving as an open question the result if a terminated member continues to hold stock in an FHLBank but comes into compliance prior to all of its stock being redeemed.

This uncertainty and instability poses a systemic risk to the FHLBank System. Chilling membership and terminating existing members, or making it too expensive for these institutions to remain members, will reverse the positive growth of the FHLBank System. Further, fewer advances will result in less money in the FHLBank System, impeding its ability to fulfill its statutory mission. These effects would be felt throughout the housing finance markets.

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[54] *See* 12 C.F.R. § 1263.30(a).

[55] *See id.* § 1263.27(b).

The proposal would be especially problematic for community banks that are at or trending toward the CFI asset cap set by the HERA (currently $1.108 billion, as adjusted for inflation.) A community bank that exceeded the cap (either by growth or through merger) would be compelled to meet the 10% residential mortgage loan test under Section 4(a)(2) of the FHLBA for the first time or risk termination of its FHLBank membership, creating significant uncertainty about the availability of FHLBank funding in future years. In addition, CFIs that exceed the asset cap may have an especially difficult time in meeting the 10% test, given that they would have only one year to restructure their balance sheet to comply with a three year rolling average and they would not have been subject to the 10% requirement in the preceding years that contribute to the average. Based on data provided by the Council of FHLBanks, since 2008: 5,622 current FHLBank members have been a CFI at some point, but only 5,253 have continuously been a CFI. Under the proposed rule, substantial uncertainty would exist for these 369 members and others over time that move above or below the CFI asset limit as to whether the 10% residential mortgage loan test applies.[56]

D. The Proposed Ongoing One Percent/Ten Percent Requirements are a Slippery Slope Away from the Direction that Congress Has Set for the FHLBanks

The FHFA's proposals and indicated future directions move the FHLBank System away from the path that has been set out by Congress. The NPRM proposes to quantify the requirement that members "make home loan mortgage loans" by mandating that, on an ongoing basis, members maintain 1% of their assets in home mortgage loans,[57] and leaves open the possibility that this percentage could be higher.[58] Section 4(a)(1)(C) of the FHLBA requires that every applicant for membership make long-term home mortgage loans.[59] An applicant can satisfy this requirement by originating or purchasing long-term home mortgage loans, which includes the purchase of mortgage-backed securities. The statute does not set a minimum threshold for the amount of home mortgage loans an applicant must make in order to satisfy this requirement, nor does the statute characterize this requirement as an ongoing requirement.[60] The NPRM's construction of the phrase "eligible to become a member" as supporting an ongoing test strains the plain language of the statute.

The FHFA's proposal would force the FHLBanks to examine their members based on a rigid, one-size-fits-all quantitative test and then require the FHLBanks to terminate non-compliant members that could not cure. This proposal impermissibly removes the discretion that

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[56] For example, Community banks at or near the CFI limit would have to manage their balance sheets to the 10% residential mortgage loan test or face the consequences of losing access to their FHLBank. A community bank acquiring another community bank with fewer mortgage related assets would face the prospect of failing the test even though it may have increased its commitment to funding residential mortgage assets in absolute dollar terms.

[57] NPRM at 54848.

[58] *Id.* at 54859 ("The agency will continue to consider whether to establish the standard at some higher percentage, such as two percent, or possibly as high as five percent . . . .").

[59] 12 U.S.C. § 1424(a)(2).

[60] *Id.* § 1424.

Congress has provided the FHLBanks, which changes the dynamic of the FHLBanks' relationships with their members. In 1989, Congress removed the FHLBanks' quasi-regulatory functions when it abolished the FHLBB.[61] Prior to FIRREA, the FHLBB had delegated to the FHLBank presidents and individual employees of the FHLBanks authority to supervise and examine Federal Savings and Loan Insurance Company ("FSLIC")-insured savings and loans.[62] The proposed ongoing requirements, which mandate that FHLBanks obtain and examine the financial statements of members on an annual basis,[63] coupled with the proposed mandatory termination requirement,[64] would force the FHLBanks back into this type of quasi-regulatory role—contrary to the actions taken through the FIRREA amendments.[65] This rigid structure far exceeds the current discretionary authority for the FHLBanks to terminate members that consistently fail to meet the FHLBank System's mission.

The NPRM thus runs counter to the continuous trend by Congress to provide the FHLBanks with greater flexibility and discretion. In 1993, in response to FIRREA, the FHFB delegated approval of new members to the FHLBanks.[66] In 1999, under GLBA, the authority to remove members was delegated from the FHFB to the individual FHLBanks.[67] The delegation of this authority allowed each FHLBank to implement policies governing approval of applicants for membership that are appropriate for its business, such as whether advances may be safely made to an applicant, and its district. This flexibility is necessary to allow the FHLBanks to provide liquidity to a broad range of member financial institutions, especially during periods of financial instability.[68]

Moreover, construing "makes home mortgage loans" as an ongoing quantitative requirement (as the FHFA proposes), coupled with mandatory termination provisions, contravenes the intent of Congress in GLBA to provide more discretion to the FHLBanks. The legislative history of GLBA indicates that Congress sought to provide the FHLBanks with more

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[61] *See* Pub. L. 101-73 § 401, 103 Stat. 183.

[62] Dirk S. Adams & Rodney R. Peck, *The Federal Home Loan Banks and the Home Finance System*, 43 Bus. Law 833, 837 (1988) (citing former 12 U.S.C. § 1437) (noting that, *before FIRREA*, one of the FHLBanks' basic missions was to "examine, supervise and regulate federally insured member institutions through Bank employees acting as agents of the Federal Home Loan Bank Board").

[63] *See, e.g.*, NPRM at 54851, 54859.

[64] *See id.* at 54867–68.

[65] The FHLBank System currently has permissive authority to terminate members that do not comply with the FHLBA or the FHFA's regulations. 12 U.S.C. § 1426(d)(2)(A) ("The board of directors of a Federal home loan bank *may* terminate the membership of any institution if, subject to the regulations of the Director, it determines . . . that the member has failed to comply with a provision of this chapter or any regulation prescribed under this chapter.") (emphasis added). The FHFA's proposals would remove the discretion provided for in the FHLBA.

[66] 58 Fed. Reg. 43522-01 (Aug. 17, 1993).

[67] GLBA § 608, 12 U.S.C. § 1426(d)(2).

[68] *See generally infra* Section I.

control over their day-to-day functions by reducing the regulatory role of the FHFB.[69] Congress highlighted that "FHFB is too involved in day-to-day management decisions of the FHLBanks."[70] Reading a quantitative definition of "makes home mortgage loans" into the FHLBA would not only be harmful to the FHLBank System but would effectively amend the statute itself. Thus, the FHFA risks moving back to a pre-GLBA state, which may only be achieved through statutory amendment.

Congress provides mechanisms to facilitate the FHLBank System's housing policy, but does so in ways that optimize the FHLBanks' abilities to tailor their services to their membership. The statutory language and regulations currently in place ensures that members continue to comply with the "makes long-term home mortgages" requirement. For example, an FHLBank, prior to approving an application for a "long-term advance," must determine that the principal amount of all long-term advances currently held by the member does not exceed the total book value of residential housing finance assets held by such member.[71] Thus, a move away from the congressionally granted discretion on the part of the FHLBanks regarding their members is unwarranted.

III. The NPRM Seeks to Re-Write the FHLBA by Excluding Captive Insurance Companies from FHLBank Membership

The NPRM proposes to "define the term 'insurance company' to exclude from Bank membership captive insurers . . . ."[72] The proposed rule would define the term "insurance company" to mean "a company whose primary business is the underwriting of insurance for nonaffiliated persons or entities."[73] Contrary to the sweeping nature of this proposal, the NPRM states only that the change is in reaction to the FHFA's "belief" that some captive insurance members may be formed by other companies, including real estate investment trusts or "REITs," to access FHLBank advances.[74] The NPRM provides no specific evidence of its claims or any discussion of the ways in which such practices would threaten the FHLBanks' mission, given the preexisting regulatory protections.

The NPRM presents far-reaching consequences for insurance company members of the FHLBank System, yet does not fully explore the scope or effect of the FHFA's proposals. The NPRM proposes to define the term insurance company, but the proposed definition adds uncertainty rather than clarity. The NPRM does not discuss how the FHLBanks should determine an insurance company's "primary business" or any guide to implementing its

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[69] S. Rep. 106-44, 18, 106th Cong., 1st Sess. 1999 (Apr. 28, 1999).

[70] *Id.*

[71] *See* 12 U.S.C. § 1430(a)(2) (necessitating residential housing finance or specific CFI-related purposes for long-term loans).

[72] NPRM at 54848.

[73] *Id.* at 54853.

[74] *See id.* at 54853–54.

proposed definition. Further, this definition may also eliminate from membership "traditional" insurance companies that also reinsure for their affiliates. Further, GLBA provided for "changes [to] enhance the ability of the FHLBank System to help member institutions serve their communities."[75] This congressional goal can only be met with individual FHLBanks being able to assess and adjust to the needs and particularities of their districts. An overarching, general-purpose blackline rule will impede the FHLBanks' abilities to work with their members to serve their communities.

Insurance companies have been eligible to be members in the FHLBank System since the original FHLBA was enacted in 1932. As recognized in the 1932 Act, insurance companies were and continue to be important participants in the housing finance sphere.[76] Although their inclusion was debated, insurance companies, as national entities engaged in housing finance across the United States, were necessary to allow the FHLBank System to function as a truly national source of liquidity for the U.S. housing finance markets.[77] With the inclusion of insurance companies, the FHLBA's intent was to achieve a diverse and robust membership and create a comprehensive framework to ensure liquidity in the housing markets. Insurance company members have proven to be critical players in promoting housing and community economic development. Insurance companies have actively participated in, and obtained, Affordable Housing Program ("AHP") grants and Community Investment Cash Advances ("CICA"). These programs are important avenues to further the FHLBanks' core mission.

A. Captive Insurance Companies Are "Insurance Companies"

The FHLBA 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."[78] The FHLBA neither defines "insurance company"[79] nor expressly authorizes the FHFA, as with the provision on banker's banks, to adopt additional rules and regulations that could further restrict ongoing membership.[80]

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[75] 145 Cong. Rec. E2343-04 (Nov. 4, 1999) (speech of Hon. Edward R. Royce).

[76] Daniel K. Maloney and James B. Thomson, *The Evolving Role of the Federal Home Loan Banks in Mortgage Markets*, Fed. Res. Bank of Cleveland 1 (2003).

[77] Congress expressed its clear desire that insurance companies, the only truly nationwide home mortgage lenders in the 1930s, should be eligible to become members of the Federal Home Loan Bank System by expressly including the term "insurance company" in the list of charters eligible to join a Federal Home Loan Bank.

[78] 12 U.S.C. § 1424(a)(1)(A) (2012) (emphasis added).

[79] *See id.* § 1422 (statutory definitions); 12 C.F.R. § 1263.1 (regulatory definitions).

[80] *See id.* § 1444(b) (stating that the eligibility of banker's banks is "subject to such additional rules and regulations as the Director may provide.").

Through its proposed regulatory changes, the FHFA expressly seeks to remove captive insurance company eligibility,[81] effectively amending the FHLBA.[82]

Since the passage of FHLBA, Congress has only acted to expand the scope of FHLBank membership. When the FHLBanks were first created, institutions eligible for FHLBank membership consisted of various forms of savings and loans, banker's banks, and insurance companies. In 1989, Congress expanded membership to include insured commercial banks, insured credit unions, and insured savings and loans.[83] Most recently, in 2008, Congress authorized CDFIs to become members of the FHLBanks.[84]

Captive insurance companies are "insurance companies" and cannot be removed from the FHLBA by agency fiat.[85] The only prior published staff guidance indicated that "insurance company" meant companies that engaged in underwriting insurance risk.[86] Captive insurance companies are formed to underwrite risks of both affiliated and unaffiliated entities. Captive insurance companies are licensed and comprehensively regulated by the state or 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.[87] Further, commenters to the ANPR have noted that captive insurance companies are subject to the same regulatory oversight as are other insurance companies.[88] Similar to other insurance companies, the ability of captive insurance companies to either lend

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[81] NPRM at 54848 (the proposed rule would define the term "insurance company" to exclude captive insurance companies from FHLBank membership).

[82] Comments of the Captive Insurance Company Association, RIN 2590-AA39, 1–2 (Mar. 27, 2011) ("[I]t is inappropriate for FHFA to discriminate against captive insurance companies based upon who they insure.").

[83] *See* FIRREA § 704, 12 U.S.C. § 1424.

[84] *See* HERA § 1206, 12 U.S.C. § 1424(a)(1).

[85] The NPRM argues that the first captive insurance company in the United States is "generally thought" to have been formed in the 1950s. *See* NPRM at 54853 n.22. However, the concept of captive insurance has existed far longer. Captives have existed since the late 1800s. Another early captive, the Church Insurance Company, was formed by the Episcopal Church in the 1920s. Shanique Hall, *Recent Developments in the Captive Insurance Industry*, CIPR Newsletter (Jan. 2012), *available at* http://www.naic.org/cipr_newsletter_archive/vol2_captive.htm.

[86] FHFB, Op. Gen. Counsel, 1998-GC-12, at 1 (Sept. 18, 1998), *available at* http://www.fhfa.gov/SupervisionRegulation/LegalDocuments/Documents/FHFB-General-Cousnel-Opinions/1998/1998-GC-12.pdf [sic].

[87] *See* NAIC, *Captives and Special Purpose Vehicles*, White Paper (July 2013).

[88] *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* (Aug. 5, 2014), 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 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.").

money or pay dividends to affiliated organizations is tightly regulated and generally requires prior review and written approval from the applicable state insurance commissioner.[89] Moreover, state courts have held that captive insurance companies are "insurance companies" and engage in the "business of insurance."[90]

Because the FHFA fails to engage in a sufficiently detailed analysis giving empirical support to its stated concern about the safety and soundness of captive insurance company membership in the FHLBank System, we cannot propose other less drastic methods in which fundamental concerns could be addressed. Each potential member that is a captive insurance company chartered by a different state has different rights and obligations with respect to third party creditors in general, as defined by state law. Treating them as all raising the same level of safety and soundness concerns seems ill considered. If any one of the over thirty-five state and territorial laws authorizing the establishment of captive insurance companies contains a specific weakness that creates a legitimate safety and soundness concern, the agency has a statutory obligation under Section 8 of the FHLBA to study such law,[91] and only after such study has been completed may it limit operations of an FHLBank with respect to such institutions, such as by restricting membership of certain classes of otherwise eligible members.

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.[92] Captive insurance companies also have reserves, surplus, policies, policyholders, and claims.[93] 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 ("D&O") liability, auto liability, and professional liability.[94] However, captive insurance companies can and do also underwrite credit risk, pollution liability, equipment maintenance warranty, and employee benefit risks (including medical benefits), personal

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[89] *See id.*

[90] *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 *bona fide* insurance company under income tax law).

[91] *See* 12 U.S.C. § 1428 (requiring an *examination* of state laws, regulations, and procedures to ensure adequate protection of the FHLBanks). Section 8 holds the FHFA to a higher standard than a mere belief.

[92] *See supra* note 88.

[93] *See id.*

[94] Hall, *supra* note 85.

accident, and *whole life insurance*.[95] While captive insurance company business models are diverse, only those that support liquidity in the housing markets, as required by current regulations, are approved for membership.[96] Advances to captives are only supported by mission-related 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 and community and economic development.

All insurance companies must be regulated in order to be eligible for FHLBank membership under the current membership regulations.[97] Current captive insurance company members meet this requirement—as seen from the critical comments on the ANPR received from state insurance regulators regarding the FHFA's proposal to eliminate captive insurance companies.[98] However, the NPRM fails to address these concerns and would eliminate a specific type of insurance company based only on non-specific references to the FHLBanks' "housing mission."

B. The FHFA Has Cited No Evidence that Captive Insurance Company Members Pose a Specific, Identifiable Harm to the FHLBank System

The FHLBanks have had captive insurance company members since 1994, indicating a long history of operating with members that are identifiable as captive insurance companies. The FHLBank System currently has twenty captive insurance company members, which account for $10.4 billion in advances. Captive insurance companies thus represent an important part of the FHLBank System's mission to provide liquidity to support FHLBank System members. Captive insurance company applicants are subject to the same scrutiny as any other member to ensure that they share the housing policies and goals of the FHLBanks.

Even accepting for the sake of argument that captive insurance companies are effectively different than the historically predominant type of insurance company members of FHLBanks, life insurance companies,[99] the FHFA does not clearly identify the nature or magnitude of any risk that captive insurance company members currently pose to individual FHLBanks or the FHLBank System. Rather, the NPRM cites non-specific concerns regarding the "relative unavailability of objective financial information and ratings," collateralization of captive insurance companies by parents, and non-diversified risk.[100]

The FHFA also neglects to weigh its non-specific concerns about captive insurance companies against the potential loss to the FHLBank System should captive insurance companies

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[95] *Id.*

[96] Comments of the Council of the FHLBanks at 2.

[97] 12 U.S.C. § 1424(a)(1)(B).

[98] *See supra* notes 83, 89; *see also infra* note 103 and accompanying text.

[99] *See* NPRM at 54853.

[100] *Id.* at 54854.

be categorically excluded from membership. As discussed above, a robust and active membership is essential to the FHLBank System's liquidity mission and a critical aspect of the FHLBanks' support of housing finance. The NPRM is completely silent on this issue—the FHFA apparently conducted no cost/benefit analysis; nor does the FHFA address the potential adverse effects of excluding a growing segment of the FHLBank System's membership.

State insurance commissioners and the National Association of Insurance Commissioners ("NAIC") have clearly addressed many of the FHFA's concerns regarding the regulation of captive insurance companies.[101] Commenting on the FHFA's ANPR, the Captive Insurance Companies Association stressed that "state captive laws contain requirements that should satisfy FHFA's supervisory concerns" by addressing:

- Licensing requirements;
- Capital and surplus standards;
- Annual financial reporting requirements;
- Regular insurance department inspections and examinations; and
- Investment restrictions.[102]

The overwhelming evidence already in the record strongly supports the proposition that no change in the current regulations regarding captives is warranted. The FHFA notes no support for its proposal in its ANPR to eliminate captives. Yet, the NPRM, although noting this lack of support, does not present any evidence as to why a categorical elimination of captive insurance companies is either necessary or advances the mission of the FHLBank System.

C. The FHFA Has Singled Out Captive Insurance Companies as a Target for Its Policy Revisions to the FHLBank System's Regulations

The NPRM argues that captive insurance companies and their use of advances are not related closely enough to the FHFA's narrowly interpreted FHLBank "housing mission"—yet allows other members to use advances to comply with international standards that bear no direct relation to the housing mission, consistent with the broad use of advances intended by Congress. As noted by the FHFA-OIG: "FHFA considers all FHLBank advances to be core housing mission assets, and only those with maturities of five years or more must be used specifically for housing purpose."[103]

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[101] *See, e.g.*, Comments of the Vermont Captive Insurance Association, RIN 2590-AA39, 1–2 (Mar. 25, 2011) (discussing the regulation, supervision, and examination of captive insurance companies); Comments of the Delaware Department of Insurance, RIN 2590-AA39 3–4 (Apr. 1, 2011).

[102] Comments of the Captive Insurance Company Association, RIN 2590-AA39, 1–2 (Mar. 27, 2011).

[103] *Id.* at 20.

The NPRM notes that advances made to a captive, especially if transferred to the captive's parent, might not be used to support the FHLBank System's "housing mission."[104] However, here the FHFA again attempts to re-write the FHLBA. There are no provisions in the FHLBA that prohibit intercompany transfers of assets or funds so long as the collateralized advance is made to an eligible member. Thus, the FHFA again singles out captive insurance companies and shrugs off the fact that bank holding companies and savings and loan holding companies (together "BHCs") would not be similarly examined as to the use of FHLBank advances by member affiliates or parent holding companies. The NPRM states that, for BHCs, these issues "could be addressed through FHFA's oversight and examination functions"[105] but does not explain why captive insurance companies would not receive equal treatment.

Even if it could be established that there is some additional risk posed by captive insurance company members of FHLBanks, current regulations and guidance are sufficient to address such risk without the need to categorically exclude these insurance companies. The FHFA's regulations and FHLBanks' internal procedures protect the FHLBanks from accepting unqualified captive insurance companies as members, just as they protect the FHLBanks from any other type of applicant that may meet the facial membership requirements, but lack a focus on the FHLBanks' housing finance goals. The current usage requirements, such as the residential housing finance asset test and the Community Support Statement certification, also ensure that members demonstrate a commitment to housing finance.

As noted above, Section 8 of the FHLBA grants the power to the Director of the FHFA to limit operations of an FHLBank with respect to specific classes of institutions eligible to become members of an FHLBank, but expressly conditions that power in two ways. First, under Section 8 of the FHLBA, the Director can only take such action after it has examined a state law and determined it to provide "inadequate protection" to the FHLBank operating there.[106] It is not clear at this stage that every state law would be judged the same if subjected to such an analysis. Second, the exercise of such power has to be conditional, and the limitation on FHLBank activity may only remain in place until the law is amended to address the specific concern identified by the Director.[107] The NPRM falls short of this requirement on both counts.

A captive insurance company, like any other member, must provide appropriate collateral for the advances made to it by its FHLBank. The nature of the collateral requirement ensures an adherence to the FHLBank System's housing finance goals. The FHFA provides no evidence that this self-enforcing mechanism of defining eligible collateral for advances would not continue to work as well for captive insurance companies as it has for the other FHLBank members. The FHLBA does not require regular advances be put to a specific use,[108] highlighting

[104] NPRM at 54853 (noting only that some captive insurance members' advances may exceed their insurance liabilities).

[105] *Id.* at 54854.

[106] *See* 12 U.S.C. § 1428.

[107] *See id.*

[108] *See* 12 U.S.C. § 1430.

an intent on the part of Congress to treat the collateral requirements and member eligibility requirements as sufficient for maintaining a nexus with the FHLBank System's housing finance goals.

The FHFA's proposed rule, if finalized, would likely receive no deference from a reviewing court, since a court could easily find that the plain meaning of the term "insurance company," as used in the FHLBA, and as intended by Congress, is clear on its face.[109] The Supreme Court has explained that the courts are "the final authority on issues of statutory construction."[110] Since the plain meaning of the term "insurance company" is clear, a reviewing court would not defer to the FHFA's interpretation using the "arbitrary and capricious" standard of review. "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[111]

The FHFA's amendment of the FHLBA through defining captive insurance companies out of the membership eligibility provisions would fail review even under the deferential "arbitrary and capricious" standard of review. A reviewing court would analyze the use, history, and context of the statutory term to determine whether the NPRM constitutes a "permissible construction" of the term "insurance company."[112] The NPRM categorically eliminates captive insurance companies based on its unsupported belief that a "small but growing number" of captives do not share the FHLBanks' mission.[113] The FHFA's belief is insufficient grounds upon which to justify a "permissible construction" of the statutory term "insurance company." More broadly, the NPRM proposes a rule that runs counter to the plain language of the FHLBA and the intent of Congress, as well as falling short of the requirements under the Administrative Procedure Act ("APA").

IV. Administrative Procedure Act

A. The FHFA's Proposals Are Contrary to the Intent of Congress

The APA requires that the FHFA's interpretation of the statute must be rational and supportable.[114] The FHFA may not justify statutory interpretation on "specious grounds."[115] An agency's interpretation must be based on a "permissible construction of the statute."[116] An interpretation that is not based on empirical facts and reasoned analysis would be found by a

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[109] *See infra* Section IV.B (noting that federal agencies may not interpret statutory language unless is it ambiguous).

[110] *Chevron*, 467 U.S. at 843 n.9.

[111] *Id.* at 842.

[112] *Id.* at 843.

[113] NPRM at 54854.

[114] *See* 5 U.S.C. 706(1)(C) (a reviewing court will "hold unlawful and set aside agency action . . . found to be . . . in excess of statutory jurisdiction, authority, or limitations, or short of statutory right . . . .).

[115] *See Cal. ex rel. Harris v. Fed. Hous. Fin. Agency*, C 10-03084 CW, 2011 WL 3794942 at *12 (N.D. Cal. Aug. 26, 2011).

[116] *See Chevron*, 467 U.S. at 843.

reviewing court to be arbitrary and capricious, *i.e.*, one that is made on unreasonable grounds or without any proper consideration of circumstances.[117]

The FHFA's burden here will be heavy because the proposed interpretation is contrary to the expressed will of Congress. The courts "must reject administrative constructions which are *contrary to clear congressional intent*"[118]—and Congress has been quite clear. Congress has had many opportunities to clarify the eligibility requirements and housing finance mission of the FHLBanks, the exact areas the NPRM seeks to address.[119] Indeed, it has done so on several occasions—in each case expanding eligibility for membership in the FHLBank System rather than contracting it.

- In 1989, FIRREA opened up membership in the Federal Home Loan Bank System to federally insured depository institutions, including eligible insured commercial banks, insured credit unions, and savings and loans.[120]

- In 1999, GLBA expanded the FHLBanks' mission by allowing CFIs to pledge small business, agri-business, and agricultural loans as collateral for advances.[121] This Act also lessened the FHLBanks' emphasis on housing finance by eliminating (i) the statutory priority for advances to Qualified Thrift Lenders ("QTLs"); (ii) the 30% FHLBank System-wide cap on advances to non-QTL members; and (iii) the advance-based stock purchase requirement for non-QTL members.[122]

- In 2008, HERA repealed the narrow language on "housing finance mission," made clear that providing liquidity (without reference to a housing component) was the primary mission[123] and recognized the importance of FHLBanks' mission of providing assistance in affordable housing and

[117] 5 U.S.C. § 706(2)(A) (under the APA, a court will set aside agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."); *see also, e.g.*, *United States v. Morton*, 467 U.S. 822, 835 (1984). An agency decision would be arbitrary and capricious if "the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicles Mfrs. Ass'n v. State Farm Mut. Ins. Co.*, 463 U.S. 29, 43 (1983).

[118] *Chevron*, 467 U.S. at 865 n.9 (emphasis added).

[119] *Id.*

[120] FIRREA § 704, 12 U.S.C. § 1424(a)(1).

[121] GLBA § 604, 12 U.S.C. § 1430.

[122] *Id.*

[123] HERA § 1201, 12 U.S.C. § 4513.

community development—including extending membership eligibility to CDFIs.[124]

Against this backdrop of a frequently-expressed and quite explicit congressional intent to expand the role of the FHLBanks, broaden their mission, and reduce unnecessary restrictions on the FHLBank System, the FHFA now proposes to do just the opposite through regulation, with no data supporting its asserted safety and soundness concerns. Where Congress has only expanded the potential membership of the FHLBanks since 1932, the FHFA seeks to limit new members and expel existing members of the FHLBanks. Where Congress has consistently broadened the focus of the FHLBanks' housing finance mission, the FHFA proposes to rigidly tie the FHLBanks to a narrow interpretation of this mission through ongoing quantitative requirements. Where Congress has eliminated the FHLBanks' role as a quasi-regulator of their members, enabling the FHLBanks to work more constructively with their membership, the FHFA intends to require that the FHLBanks police their membership and terminate members that do not meet the FHFA's standards, regardless of the actual situation faced by the individual FHLBank and the individual member. Further, even if such changes were needed, Congress must act to pass statutory direction before the FHFA may impose any new membership requirements.

B. The FHFA Has No Authority to Amend the FHLBA

The FHFA may promulgate and enforce regulations and orders to carry out the provisions of the FHLBA. However, *the FHFA does not have authority to amend the FHLBA*.[125] The FHFA must interpret its authorizing statute based on the plain meaning of the statutory text. The FHFA may not stray from the plain language of the statute unless a term or phrase is unclear or ambiguous. To assist in interpreting words or phrases that are unclear or ambiguous, the FHFA may turn to the legislative history of the statute, established canons of statutory constructions, and its own reasoned analysis.[126] However, none of these tools allows for rewriting the statute.

An agency decision must rely only on factors that Congress has intended it to consider, consider all important aspects of the problem, and offer a plausible explanation supported by evidence.[127] The NPRM violates these administrative law precepts. First, the NPRM highlights the FHFA's belief that some members' use of advances is not consistent with the FHLBank System's "housing mission," ignoring the fact that Congress chose to address this one component of the FHLBanks' expanded statutory mission through restrictions applicable only

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[124] *Id.* § 1206, 12 U.S.C. § 1424(a)(1).

[125] *See* 5 U.S.C. § 706(2)(C).

[126] *See, e.g.*, *Fox Television Stations v. FCC*, 129 S. Ct. 1800, 1810-11 (2009); *see also* FHFB, Memorandum from Philip L. Conover to Beth L. Climo (Aug. 29, 1991), *available at* http://www.fhfa.gov/SupervisionRegulation/LegalDocuments/Documents/FHFB-General-Cousnel-Opinions/1991/1991-GC-20.pdf [sic]. The FHFA's "beliefs," *see, e.g.*, NPRM at 54852–53, do not constitute "reasoned analysis."

[127] *See Motor Vehicles Mfrs. Ass'n*, 463 U.S. at 43.

for long-term advances and left general advances to the members' discretion.[128] Second, Congress has made clear, and the FHFA has affirmed, that a central mission of the FHLBank System is to provide liquidity to support FHLBank members.[129] The NPRM fails to address the FHLBanks' role in ensuring liquid markets, nor does it analyze the potential harmful effect that its proposals would have on the FHLBank System's ability to achieve this mission and the possible systemic impact on the U.S. economy that could result from its proposed changes. Third, the FHFA notes that ongoing membership requirements are needed to protect the FHLBank System's "housing mission," but presents evidence that an overwhelming majority of members are and would be in compliance—thus calling into question the need for the regulatory overhaul. Fourth, the NPRM proposes to create from whole cloth a significant and burdensome regulatory role for the FHLBanks *vis à vis* their members, remove FHLBank discretion, replace such discretion with rigid, one-size-fits-all rules, and categorically eliminate an existing category of FHLBank System member. These changes run counter to the clear congressional intent to do just the opposite. The problems asserted by the FHFA, as well as their proposed solutions, simply do not fit the facts: The FHFA proposes a solution without a problem.

C. The NPRM Lacks a Rational Basis for Its Proposals

Agencies may not provide an explanation for a final rule that is "too conclusory to permit [a reviewing court] to evaluate its rationality."[130] Courts insist that the compliance with the APA requires that interested parties be provided with an explanation based upon fact that may justify the departure "from a settled course of behavior."[131] Because the FHFA is bound by the rules and requirements set out in the APA, the regulator's interpretation of the statute must be reasonable. The deference granted an agency under the "arbitrary and capricious" standard is not unlimited. A final rule may thus be remanded if an agency relies on insufficient empirical data, ignores the costs that would be imposed by the rule, or does not maintain some consistency with the overall structure of its rules.[132]

The FHFA's proposals in the NPRM, if adopted, would violate this administrative law mandate. Ignoring these administrative law principles would cause the FHFA's final rule to not receive the highest level of deference from a reviewing court. The FHFA's NPRM provides little insight into the specific problems that the FHFA seeks to correct with its proposed

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[128] 12 U.S.C § 1430 (requiring a purpose only for "long-term advances").

[129] *See* Section II.B.

[130] *See Am. Petroleum Inst. v. Johnson*, 541 F. Supp. 2d 165, 184 (D.D.C. 2008) (noting that courts will not "guess at the theory underlying the agency's action").

[131] *Id.* at 182.

[132] *See Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *see also, e.g., Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962); *FTC. v. Sperry & Hutchinson Co.*, 405 U.S. 233 (1972) (stating that the Court could not sustain an order that failed to "articulate any rational connection between the facts found and the choice made"); *Heartland Reg'l Med. Ctr. v. Sebelius*, 566 F.3d 193, 199 (D.C. Cir. 2009) (noting that an agency proposing a rule must provide facts and must articulate some "rational connection between the facts found and the choice made").

regulation. The NPRM does not respond to the concerns raised by stakeholders commenting on the FHFA's ANPR, but rather dismisses this overwhelmingly negative feedback despite having several years between the issuance of the ANPR and the NPRM to refine its proposals. Thus, there is scant indication in the NPRM that the FHFA considered the comments filed on the ANPR. The NPRM states that "FHFA received 137 comment letters in response to the ANPR, almost all of which opposed revising the membership regulation in any of the ways discussed in the notice . . . ."[133] Its response to these comments was summarily dismissive.[134] As a result, despite its length, the NPRM passes from the "tolerably terse" to the "intolerably mute."[135]

D. The FHFA's Proposals, if Adopted, Would Impose an Undue Regulatory Burden

By requiring continuous compliance with initial membership requirements, the FHFA seeks to impose new regulatory burdens not only on the FHLBanks, which must collect and examine financial statements of their entire membership annually, but also on individual members, particularly smaller institutions. A 2011 Executive Order on Federal regulations encourages a more balanced approach and emphasizes that Federal regulators should find the simplest, least costly and least burdensome way to implement new requirements.[136]

The proposals in the NPRM run counter to this Executive guidance. The proposals will unnecessarily create a cumbersome and mechanical regulatory structure that will increase costs of membership in the FHLBank System. Further, they introduce complexities and uncertainties into the FHLBank System. The NPRM discusses no specific and identifiable problems that these new regulations will correct, but rather selectively limits the FHLBank System's broader general purpose to an excessively narrow "housing mission" that the FHFA fears some members do not sufficiently advance. Thus, both APA principles and Executive guidance argue against the finalization of the NPRM.

Conclusion

For the reasons discussed above, we respectfully request that the FHFA withdraw its NPRM. Should the FHFA continue to hold to its beliefs that gave rise to the NPRM, it must take those concerns to the Congress and seek statutory changes to the FHLBA. The FHFA's

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[133] NPRM at 54850.

[134] *See* NPRM at 54850 (listing global complaints regarding the ANPR, such as a lack of purpose and potential harmful impact on the FHLBank System's mission to provide liquidity to the housing finance markets, but not addressing these issues). Similarly, the NPRM fails to address threshold issues and seeks comments on specific issues without discussion of the broader framework.

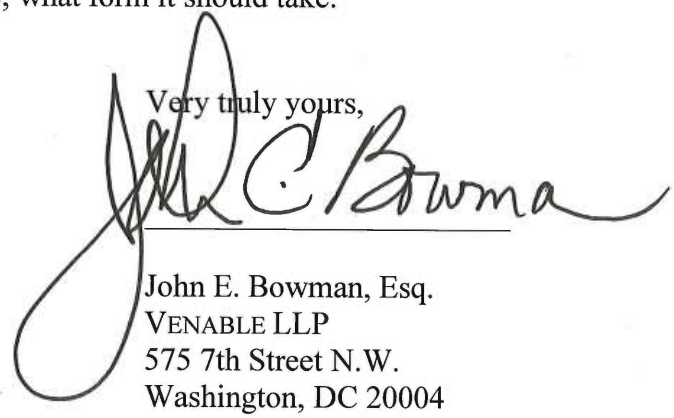
[135] *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970).

[136] *Cf.* Improving Regulation and Regulatory Review, Exec. Order No. 1356376, 76 Fed. Reg. 3821 (Jan. 18, 2011). The executive order requires government regulation to support, not undermine, economic growth and job creation. "In developing regulatory actions and identifying appropriate approaches, each agency shall attempt to promote . . . simplification . . . ." *Id.*

proposals, including ongoing membership requirements, elimination of captive insurance companies, and mandatory terminations of membership, contravene the plain language of the FHLBA. Since in these areas the FHLBA is clear on its face, the FHFA has no grounds to interpret these provisions. Further, even if interpretation of these issues is permissible, the FHFA fails to provide the required rational basis for its proposed rules. The NPRM violates the purposes of the FHLBA as amended by Congress. The NPRM also contradicts one of the FHFA's charges under the Safety and Soundness Act to "ensure that . . . the operations and activities of each regulated entity *foster liquid, efficient, competitive, and resilient* national housing finance markets."[137] Far from meeting this statutory obligation, as discussed above, the NPRM imposes rigid restrictions that will serve only to weaken the FHLBanks' efforts to foster liquid and resilient housing finance markets and shrink the FHLBanks' membership. The proposals thus violate the FHLBanks' congressionally mandated mission of providing liquidity to its their members in connection with the FHLBank System's housing finance goals.

In the alternative, we would request that the FHFA suspend further rulemaking on this proposal until such time as the FHFA finds itself in a position to adequately identify the problem(s) that this proposal is intended to address. During the suspension period we strongly encourage the FHFA to schedule and then to hold a series of public meetings, workshops, or roundtable discussions across the country with the numerous stakeholders who will be directly impacted by the proposal if it were to be finalized in its current format. While we would leave the agenda, actual number of and locations for these meetings to the FHFA, the public hearings would serve as a useful collection point for the FHFA in better understanding the "problem," if any, that the proposal is intended to address, as well as alternative solutions to any problem(s) that might exist and both the intended and unintended consequences of the proposal. Interested stakeholders, who at a minimum should be invited to attend a public hearing at a site that is convenient for them include: Members of the FHLBanks and their prudential regulators (both state and Federal), the FHLBanks, and recipients of programs that are a part of the FHLBanks and their mission. The FHFA must engage these parties in a more fulsome discussion regarding whether additional regulation is needed and if so, what form it should take.

Very truly yours,



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[137] 12 U.S.C. § 4513(a) (emphasis added).