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Federal Home Loan Banks

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Executive Summary

- The Federal Home Loan Bank (FHLB) system was established in 1932 for the purpose of providing liquidity and transparency to the capital markets.
- It is comprised of 11 regional banks that are government-sponsored entities (GSEs) and support the market for homes. These FHLB regional banks provide low-cost financing to member financial institutions, which in turn make loans to individuals.
- Each FHLB regional bank is structured as a cooperative of mortgage lenders, or members, which sets its credit standards and lending policies. To become a member, a financial institution must purchase shares of the regional bank.
- FHLB regional bank members may apply for a loan or “advance” based on required credit limits and borrowing capacity. Each loan or advance is secured by eligible collateral, and lending capacity is based on applicable discount rates on the eligible collateral. The more liquid and easily valued the collateral, the lower the discount rate.
- Eligible collateral may include U.S. government or government agency securities; residential mortgage loans; residential mortgage-backed securities (RMBS); multifamily mortgage loans; cash; deposits in an FHLB regional bank; and other real estate-related assets such as commercial real estate loans.
- U.S. insurers interact with the FHLB system via borrowing, investing in FHLB debt and owning stock in FHLB regional banks.

Established in 1932 by an act of the U.S. Congress in response to the Great Depression, the FHLB system supports the market for homes by making related capital markets more efficient and transparent. The FHLB system is comprised of 11 regional banks that are privately owned as cooperatives by their members; only financial institutions may belong to an FHLB. Instead of making loans directly to individuals, the FHLB regional banks provide low-cost financing to the financial institutions that extend

loans to homeowners, resulting in the availability of affordable mortgages. About 80% of U.S. lending institutions rely on FHLB regional banks for financing, and they have been an essential part of the country's financial system for more than eight decades. Each FHLB regional bank is registered with the U.S. Securities Exchange Commission (SEC), and they are each a GSE supervised and regulated by the Federal Housing Finance Agency (FHFA).

The FHLB Office of Finance serves as a fiscal agent for the FHLB system and is primarily responsible for issuing and servicing debt securities for the 11 FHLB regional banks. It also is responsible for FHLB financial statements publication and analysis, as well as educational outreach relative to FHLB debt products. Additionally, it provides the FHLB regional banks with capital and general market data and analysis. The FHLB regional banks effectively fund their operations through selling debt securities via the Office of Finance.

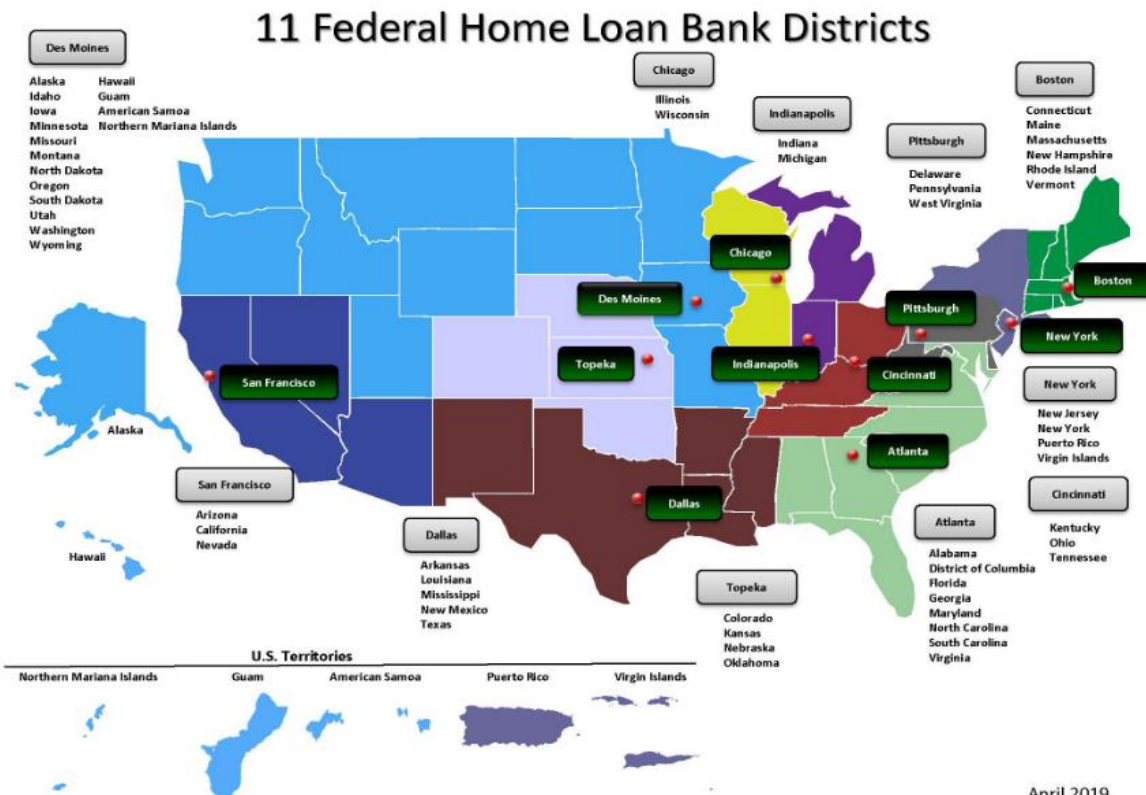
FHLB Structure

Cooperative Structure

Each of the 11 FHLB regional banks that comprise the FHLB system is assigned a zone within the U.S., which typically consists of three or more states or U.S. territories as identified in the map below.

The 11 Regional Federal Home Loan Banks

There are regional FHLBanks located in: Atlanta, Boston, Chicago, Cincinnati, Dallas, Des Moines, Indianapolis, New York, Pittsburgh, San Francisco, and Topeka.



April 2019

The FHLB system is organized as a cooperative of approximately 7,000 financial institutions, or members that vary by size and type. FHLB members include banks, thrifts, credit unions, community development financial institutions and insurance companies; commercial banks comprise the largest share at about 60% of the total, while U.S. insurers make up less than 10%.¹ (See the Appendix.) As a cooperative, the members set the credit standards and lending policies, elect the board of directors and, ultimately, take responsibility for the FHLB regional bank. If a mortgage originator or commercial bank or insurer wishes to apply for a loan (referred to as an “advance”) from the local FHLB regional bank, it must first become a member of the cooperative by purchasing shares of FHLB capital stock. The number of shares required for membership varies by FHLB regional bank. The shares cannot be sold to others; i.e., they are not publicly traded, in part because they confirm membership in the FHLB regional bank. The shares may be redeemed at the appropriate FHLB regional bank for repayment at par, but only after a notice period and only after all advanced amounts are repaid in full. Prepayment of outstanding advances prior to the stated maturity may not be permitted, or if permitted, can result in significant penalties.

Once a company (e.g., an insurer, a bank, or a savings and loan, typically) becomes a member of the FHLB system, it is free to apply for a loan (advance). Advances are the FHLB regional banks’ largest asset category. Prior to applying for an advance, a member must acquire activity-based FHLB stock in an amount equal to a specified percentage of the outstanding principal balance of the extended advance.² No individuals may become FHLB members.

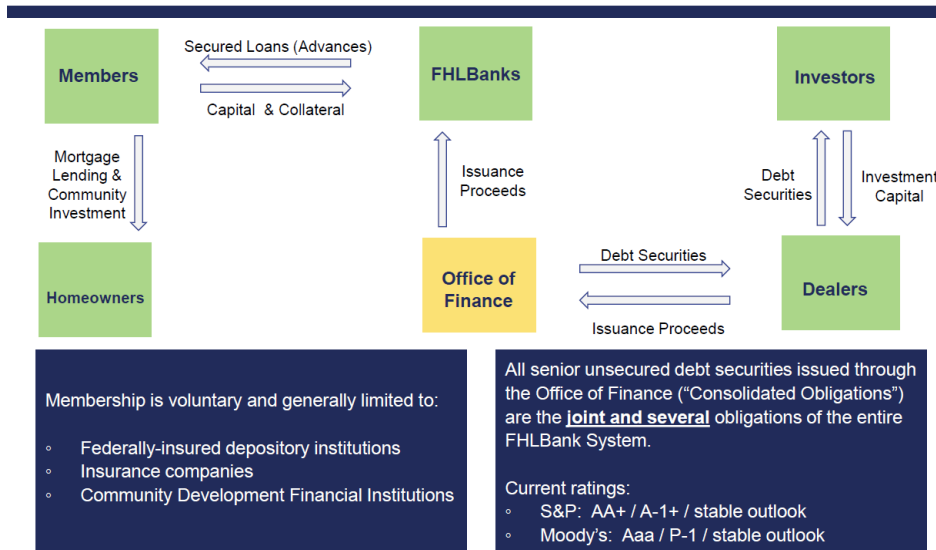
Background on FHLB Loans

The purpose of the FHLB system is to provide liquidity and transparency to the capital markets supporting home ownership. As FHLB regional banks provide low-cost financing to companies that extend loans to homeowners, they, in turn, lower costs for all. The diagram below shows how the FHLB regional banks fund liquidity.

¹ FitchRatings, *The Federal Home Loan Bank System and System Banks*, June 2020.

² FHLB New York, FHLB System Debt and Capital Stock Overview.

FHLBanks Provide Liquidity



Source: FHLB Office of Finance Investor Presentation, December 2020.

Centralized Financing

FHLB regional banks tend to carry large cash balances, so most small advances are funded from cash on hand. However, when cash stores run low or an advance is too large to fund by cash on hand, the FHLB regional bank requests funding from the Office of Finance.

The Office of Finance serves as a centralized financing arm of the FHLB regional banks. It maintains relationships with the capital markets while consolidating and distributing summary financial results. It also arranges the bond issues and discount notes (referred to as consolidated obligations) used to fund all 11 FHLB regional banks. The FHLB regional banks share the funds raised by the Office of Finance, and all the FHLB regional banks also share the obligation to repay the debt. Thus, each FHLB regional bank is legally responsible for repayment of its own debt, plus the debt of all other FHLBs. The joint and several nature of consolidated obligations, along with the support of the federal government, allows the Office of Finance to issue debt at low costs. This results in lower interest costs for members.

FHLB Lending and Collateral

Each member is subject to credit limits, and borrowing capacity is evaluated ongoing, based on a review of creditworthiness and collateral management practices. The FHLB regional banks require all loans to be fully supported by collateral, with overcollateralization determined by the type of collateral provided. The board of directors of each FHLB regional bank establishes its own collateral policy that is consistent with statutory and regulatory requirements. The collateral policy identifies the types and amounts of eligible collateral the FHLB regional bank will accept. Collateral policies often differ across the FHLB regional banks because of differences in the types of members served, the risk tolerances, and the methods and vendors used by each FHLB regional bank to determine collateral lendable values. Major

collateral policy differences between the FHLB regional banks include the different types of eligible collateral each regional bank will accept, the levels of collateral discount required, and the conditions under which a member must deliver its collateral to be able to borrow. In its more than eight-decade history, the FHLB regional banks have not experienced any credit losses on advances due in part to their eligible collateral requirements.

Lending capacity is based on applicable “haircuts” (or collateral discount rates) on eligible collateral. The FHLB regional banks apply a haircut to either the market value of eligible collateral or the book value of eligible collateral.³ The haircut represents the difference between the book value of collateral pledged and borrowing capacity, or the amount a regional bank is willing to lend to the member for the specific collateral type. Haircuts vary based on the collateral type pledged, and they generally increase with the perceived risk of the collateral type. That is, the more liquid and more easily valued the asset posted as collateral, the lower the discount taken against the collateral’s value. Haircuts are intended to ensure that the liquidation value of pledged collateral exceeds the value of the product it is securing.

The majority of eligible collateral securing advances includes single family mortgage loans, such as prime, subprime and those guaranteed by government entities (e.g., Federal Housing Authority [FHA] and Veterans Administration [VA]). In addition, commercial real estate is a common form of collateral, as are multifamily mortgage loans, agency-backed mortgage securities and home equity loans/lines of credit, among others. Collateral in the form of securities must be rated single-A or higher by a credit rating agency and is either delivered directly to the FHLB regional bank or to a securities custodian. Any whole loan mortgage collateral must be in good standing (i.e., not more than 90 days delinquent, though most FHLB regional banks restrict to 30 to 60 days delinquent).

The table below shows the various possibilities of collateral types pledged to secure FHLB advances, with corresponding weighted average haircuts. As the table below shows, other real estate-related collateral (ORERC) tends to have larger haircuts; commercial real estate (CRE) is the largest collateral type in the ORERC category.

³ FHFA, *Report on Collateral Pledged to Federal Home Loan Banks*, November 2020.

Collateral Category	Weighted Average Effective Haircut
SF 1st lien	17.8%
MF	23.6%
ORERC: CRE	29.7%
ORERC: HELOCS and SF 2nd lien	38.3%
ORERC: Land	50.4%
Other ORERC	25.3%
CFI	45.7%
Agency MBS/CMOs	2.5%
Non-MBS Agency Securities	1.2%
CMBS	11.3%
PLMBS	35.3%
Other Securities	16.9%

Source: www.FHFA.gov - November 2020 Report on Collateral Pledged to Federal Home Loan Banks; SF = single family; MF = multifamily; CFI = community financial institution; HELOCS = home equity lines of credit; MBS = mortgage-backed securities; CMOs = collateralized mortgage obligations; CMBS = commercial mortgage-backed securities; and PLMBS = private label MBS.

Collateral is regularly revalued by FHLB regional bank management. If values fall below acceptable levels, additional collateral contributions or protections need to be provided by the member. FHLB regional banks do not restrict how proceeds from an advance may be used.

U.S. Insurers as FHLB Members

Insurance companies interact with the FHLB system in primarily three ways: 1) they borrow from the FHLB regional banks; 2) they invest in FHLB debt; and 3) they own stock in local FHLB regional banks. The most-often cited reason that insurers prefer FHLB regional banks over commercial lenders are the favorable interest rates that FHLB offers its members. The FHLB system can issue bonds near the risk-free rate—that is, at borrowing rates close to those of the U.S. Department of the Treasury (Treasury Department). Much of the savings in reduced interest expense is then passed along to the FHLB regional bank member borrowers.

While insurers benefit from lower-cost debt, FHLB regional banks also benefit from transacting with insurers, as they tend to be large borrowers. U.S. insurers (like other FHLB members) must first purchase FHLB capital stock as specified in the FHLB regional bank’s capital plan. The FHLB regional bank may issue two classes of capital stock, each with sub-classes.⁴ Class A stock, when issued, may be redeemed by members after giving six -months’ written notice. Class B stock, however, requires members (insurers) to provide the FHLB regional bank a five-year notice prior to redeeming the stock, subject to certain restrictions. Therefore, Class B stock is illiquid and not readily available. Most FHLB regional banks issue Class B stock with sub-classes that represent either membership or activity-based stock requirements.

⁴ FHLB, Discussion of the FHLBanks’ Capital Structure and Regulatory Capital Requirements, November 2020.

According to the FHLB Chicago regional bank, membership by U.S. insurers (which includes seven eligibility requirements shown in the “The Path to Membership” sidebar below) has increased at an annual compound rate of 8.6% over the decade ended 2020. More than 500 U.S. insurers are FHLB members, including life, health and property/casualty (P/C) companies. (See the Appendix.)

The Path to Membership

To be eligible for membership in an FHLBank, an insurance company must:

- Be duly organized—the institution must be chartered by a state agency
- Be subject to inspection and regulation—the institution must be subject to inspection and regulation under the insurance laws of any state
- Make long-term home mortgages—the institution must either originate or purchase long-term (five years or longer) home mortgage loans (including mortgage-backed securities backed by qualifying loans and securities)
- Exhibit safe financial condition—the institution’s financial condition must be such that advances may be safely made to it
- Show sound character of management and home financing policy—the character of the institution’s management and home financing policy must be consistent with sound and economical home financing
- Meet the definition of an insurance company—the institution must hold an insurance license or charter under the laws of a state, and its primary business must be the underwriting of insurance for persons or entities that are not its affiliates
- Have mortgage-related assets that reflect a commitment to housing finance

Source: FHLBC.com

Note that in January 2016, the FHFA issued a rule on FHLB membership such that captive insurers were no longer eligible in order to reduce exposure to lesser-regulated entities. Captive insurers were initially permitted to become members in September 2014; those who became members at that time had their memberships terminated in January 2017, and any remaining (that became members after September 2014 but prior to the 2016 rule clarification) have until February 2021 until their memberships are mandatorily terminated.

U.S. Insurer FHLB Advances - Debt or Funding Agreement?

At certain FHLB regional banks, insurers have represented 5% of the membership and 10% or more of the advances. FHLB advances are a stable source of low-cost funding for U.S. insurers, with maturities ranging from overnight to more than 10 years, and their term and structure may be tailored. FHLB advances represent an additional funding source and easy access to capital. The vast majority of FHLB advances to U.S. insurers have historically been with life companies; however, a smaller number of property/casualty (P/C) and health companies have also become FHLB members. Since 2010, FHLB advances to U.S. insurers have been steadily increasing. (See the Appendix.)

Advances may be in the form of debt or, more commonly, in the form of funding agreements (for those life companies licensed to issue deposit-type contracts). Funding agreements are deposit-type contracts that pay a guaranteed rate of return over a specified time period. Advances may be used for a variety of purposes, such as cheap funding and a liquidity source, but increasingly U.S. insurers have been using them for financial leverage (i.e., spread investment). That is, they borrow funds at a relatively low rate from FHLB and invest in higher yielding assets, thus generating income off the spread. The November

2020 *Financial Stability Report* published by the Federal Reserve noted an increased use of advances by U.S. insurers coinciding with an increase in illiquid assets in their general accounts and, therefore, increased liquidity risk.⁵ That is, U.S. insurers are, perhaps, pledging high-quality, low risk bonds as collateral for FHLB advances and, in turn, reinvesting the advance proceeds in higher yielding, less liquid assets.

About 75%–80% of FHLB advances to U.S. insurers are in the form of funding agreements. When issuing a funding agreement in connection with the borrowing, the obligation to return the borrowing is reflected in the reserve established for the insurance contract (deposit-type contract). If an insurer borrows outside of the deposit-type contract structure, the borrowing is classified as debt.

Notwithstanding, in addition to reporting FHLB advances, U.S. insurers must also disclose information relative to corresponding FHLB activity—that is, information on FHLB common stock held (because they can only borrow if they own FHLB stock), collateral pledged to the FHLB regional bank, and whether the advances are subject to prepayment penalties.

What Types of Eligible Collateral Do U.S. Insurers Use to Secure FHLB Advances?

FHLB advances are fully collateralized by a wide variety of eligible collateral types. U.S. insurers have historically offered FHLB regional banks high-quality collateral—i.e., liquid securities, such as U.S. Treasury and government-sponsored agency bonds, instead of (less liquid) home mortgages. However, the mix of assets an insurer posts as collateral could change, if and as insurers are required to allocate higher-grade agency and Treasury securities to other counterparties (e.g., derivatives clearinghouses). Thus, while an insurer might be drawn to an FHLB loan due to the lower interest rate, by lending to insurers, in turn, FHLB regional banks benefit from an improvement in the quality of their collateral pool. Statutory accounting requires U.S. insurers to disclose amounts reported in their annual statement that are held or restricted (i.e., pledged collateral to the FHLB). Additionally, U.S. insurers are required to disclose FHLB activity outstanding as of reporting period end-dates, as well as the maximum amount of borrowing at any point in time and collateral pledged that occurred throughout a reporting period. This allows for identification of significant increases/decreases in FHLB activity outside of set reporting dates. In addition to borrowing money from the local FHLB regional bank, U.S. insurers also have the option to invest in FHLB securities.

FHLB Investment Portfolios

FHLB regional banks primarily invest in highly rated securities—that is, those rated AA or higher by credit rating agencies. In addition, FHLB regional banks are only permitted to acquire mortgage-backed securities with the highest credit quality, or those rated AAA. The FHLB regional banks' investment strategy is to enhance interest income such that sufficient funds are available to pay operating expenses and strengthen its capacity to meet affordable housing commitments.

⁵ Board of Governors of the Federal Reserve System, *Financial Stability Report*, November 2020.

FHLB Governance and Regulation

Each FHLB regional bank has its own board of directors that is comprised of members of that FHLB regional bank, as well as independent (non-member) directors. By statute, two-fifths of the directors must be independent, and at least two of those directors must be public interest directors with at least four years of experience in representing community or consumer interests. Directors serve four-year terms and may not serve more than three consecutive terms.

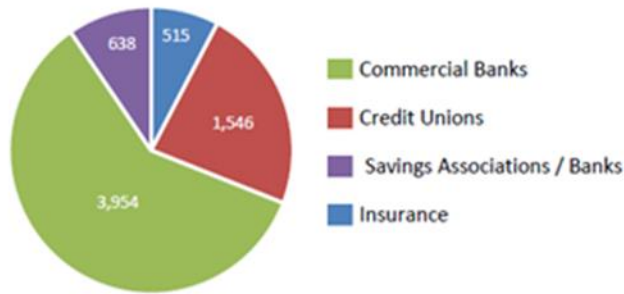
The FHFA, created by Congress in the federal Housing and Economic Recovery Act of 2008, is the regulator charged with overseeing the FHLB regional banks. The FHFA is led by the FHFA Director and advised by a Federal Housing Finance Oversight Board.

For more detail on FHLB, please see the [FHLBanks](#) website.

Appendix⁶

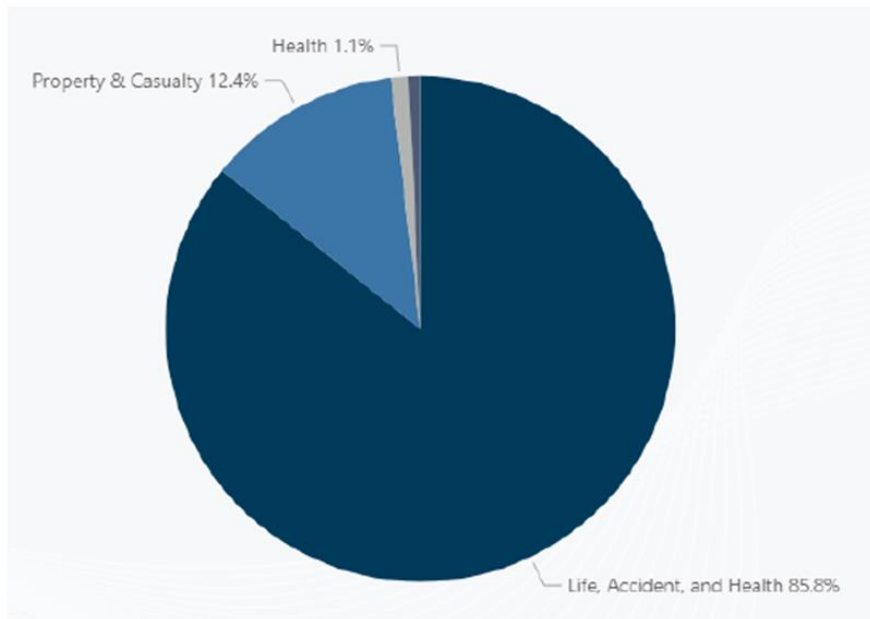
Membership Snapshot

Nearly 6,700 members across 11 FHLBanks having total assets in excess of \$29 trillion



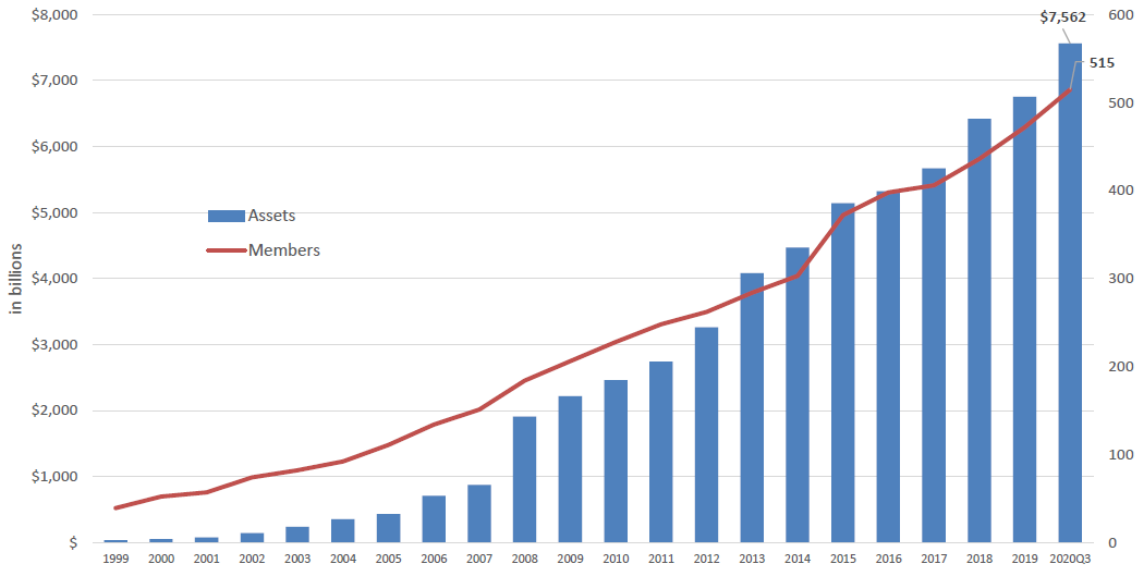
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U.S. Insurer FHLB Membership

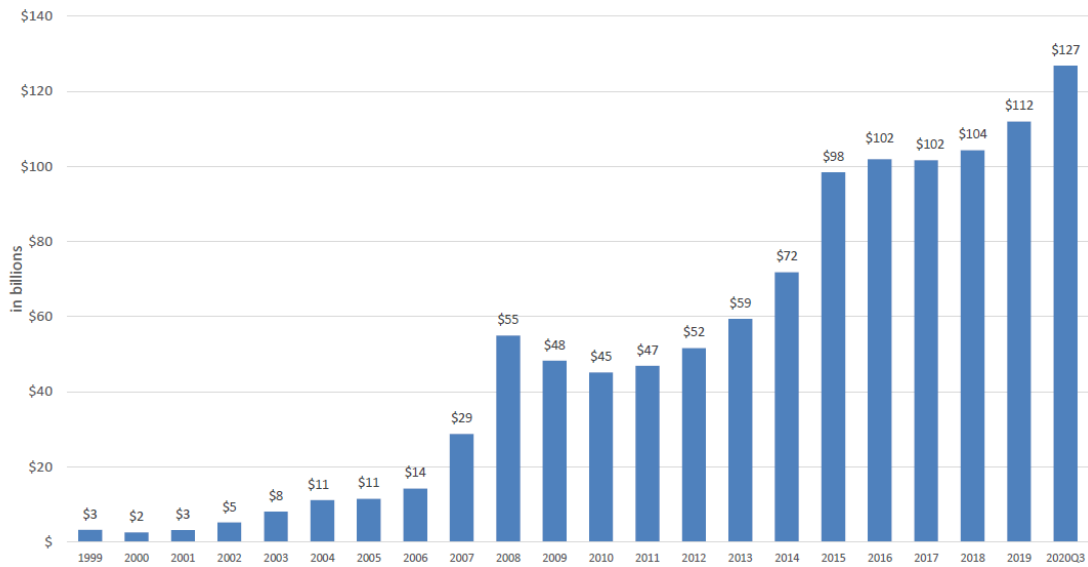


⁶ FHLBanks Update to the NAIC, December 2020.

FHLBank System Insurance Membership Trend



FHLBank System Insurance Advances Trend



Key Terminology

Advance

A loan from an FHLB regional bank.

Book Value

Unpaid principal balance of pledged collateral.

Borrowing Capacity

Lendable value of collateral pledged based on member and collateral type, net haircuts.

Consolidated Obligations

Bond issues and discount notes used to fund the 11 FHLB regional banks.

Cooperative Structure

Each of the 11 FHLB regional banks is a government-sponsored entity (GSE) organized as a cooperative of mortgage lenders, or members, pursuant to the Federal Home Loan Bank (FHLB) Act of 1932. The FHLB regional banks are owned by about 7,000 members varying by size and type. As a cooperative, the members set the credit standards and lending policies and elect the board of directors.

Discount Rate/“Haircut”

The difference between the book value of the collateral pledged and the borrowing capacity, or amount the regional bank is willing to lend a member; the haircut varies based on collateral type pledged, increasing with perceived risk.

Eligible Collateral

Including but not limited to residential mortgage loans, such as traditional prime, subprime and those backed by government entities (e.g., Federal Housing Administration [FHA] and Veterans Administration [VA]), as well as commercial real estate, multifamily mortgages, other real estate-related collateral, agency-backed securities, home equity loans and lines of credit, among other types. Securities that are posted as collateral must be rated single-A or higher by a credit rating agency.

Federal Housing Finance Agency (FHFA)

The FHFA is an independent federal agency established under the federal Housing and Economic Recovery Act (HERA) of 2008. Its responsibilities include overseeing Fannie Mae and Freddie Mac, as well as the 11 FHLB regional banks.

Federal Home Loan Bank (FHLB)

A system that supports the market for homes and is comprised of 11 regional banks that are privately owned as cooperatives by their members, which may only be financial institutions. FHLB regional banks provide low-cost financing to financial institutions members, which then extend loans to homeowners. This results in an availability of affordable mortgages.

FHLB Office of Finance

Fiscal agent for the FHLB system primarily responsible for issuing and servicing debt securities for the 11 FHLB regional banks. It is also responsible for FHLB financial statements publication and analysis, as well as education outreach relative to FHLB debt products. Additionally, it provides the FHLB regional banks with capital and general market data.

Funding Agreement

Deposit-type contract that is sold by life companies and pays a guaranteed rate of return over a specified time period.

Government-Sponsored Enterprise (GSE)

A quasi-governmental, privately held agency established by Congress that provides financial services, in particular mortgages, to improve credit flow.

Member

A financial institution that has been approved for membership and has purchased stock in an FHLB regional bank.

Membership Stock

Stock that an FHLB member is required to purchase and hold as a condition of membership in the FHLB regional bank.

Other Real Estate Related Collateral

Real estate collateral that is not private label mortgage-backed, such as second mortgage loans, home equity loans and commercial real estate.

Links to Previously Published FHLB-Related NAIC Capital Markets Bureau Reports:

Jan. 9, 2018 – [U.S. Insurer Exposure to the FHLB System as of Year-End 2016](#)

Sept. 13, 2016 – [U.S. Insurer Exposure to the Federal Home Loan Banking System as of Year-End 2015](#)

Dec. 14, 2012 – [The U.S. Insurance Industry's Exposure to the Federal Home Loan Banking System](#)