

Client Alert

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FHFA Final Rule on Federal Home Loan Bank Membership Impacts Mortgage REITs

On January 12, 2016, the Federal Housing Finance Agency (“FHFA”) released a final rule that amends regulations governing Federal Home Loan Bank (“FHLBank”) membership. The final rule, which largely adopts the provisions included in the Notice of Proposed Rulemaking issued by the FHFA in September 2014 (“Proposed Rule”), will prevent captive insurance companies, including the captive insurance subsidiaries of a number of publicly traded mortgage real estate investment trusts (“Mortgage REITs”), from obtaining and maintaining FHLBank membership and, consequently, accessing low-cost funding through the FHLBank-system. Mortgage REITs are frequently viewed as providing an important source of private funding to the residential mortgage finance industry.

The FHLBank-system comprises 11 federal home loan district banks and an office of finance that are regulated by the FHFA. FHLBanks, which were created under the Federal Home Loan Bank Act (“Bank Act”) to, among other things, improve the availability of residential housing finance, are cooperatively owned by more than 8,000 member institutions. The FHLBanks provide members low-cost advances that are fully secured by certain forms of collateral, including conventional one- to four-family residential mortgage loans, certain commercial real estate loans, agency RMBS and nonagency RMBS that meet certain credit standards.

Under the Bank Act there are generally four types of institutions that are eligible for FHLBank membership, including federally insured depository institutions, insurance companies, certain credit unions and certified community development financial institutions.¹ Prior to the FHFA’s issuance of the final rule, the term “insurance company” had never been defined under the Bank Act or existing regulation.

Captive insurers, which are typically wholly-owned and insure the risks of their owners, were first admitted as FHLB members more than 20 years ago. However, prior to mid-2012, no more than 12 captives were members of the FHLBank.² As large, private financial institutions reduced the availability of repo financing in recent years due in large part to new bank capital requirements, Mortgage REITs have increasingly sought alternative financing sources. Starting in mid-2012, a few public Mortgage REITs began forming captive insurance subsidiaries that applied to become FHLBank members. Subsequent to this time, a number of other public Mortgage REITs followed suit and applied for and obtained FHLBank membership. According to the FHFA, since mid-2012 FHLBanks have admitted 27 captive insurance companies as new members, 25 of which are owned by Mortgage REITs, finance companies and other types of entities that are not themselves otherwise eligible for FHLBank membership. Consistent with the more than threefold increase in captive membership during this period, total outstanding advances to captive

¹ See Federal Housing Finance Agency Final Rule: Members of Federal Home Loan Banks, RIN 2590-AA39 (January 12, 2016) at 5-6 (Final Rule on FHLBank Membership for Captive Insurers).

² See Final Rule on FHLBank Membership for Captive Insurers at 34.

insurance company members increased from approximately \$12 billion in 2011 to approximately \$35 billion as of September 30, 2015.³

As part of a continuing review of the FHFA's bank membership regulation that began in 2010, the FHFA published the Proposed Rule in September 2014. Concerned with the increasing FHLB membership of captive insurers whose parent companies were otherwise ineligible to join the FHLB and the growing potential for entities other than Mortgage REITs to access the FHLBanks in this manner, the FHFA sought, among other things, to close what they considered to be a loophole in the membership regulations, by defining in the Proposed Rule the term "insurance company" to exclude "captive insurers." The FHFA received more than 1,300 comment letters in response to the Proposed Rule, 400 of which addressed the FHFA's proposal to exclude captive insurers from FHLBank membership. According to FHFA, nearly all 400 of the letters addressing the exclusion of captives expressed opposition to all aspects of the Proposed Rule on captives, with the bulk of the arguments falling into two primary areas: (1) the FHFA lacks legal authority to implement the Proposed Rule and exclude captives and (2) the exclusion of captives is unsound on a policy basis.⁴

In issuing the final rule, the FHFA adopted substantially all the provisions from the Proposed Rule with respect to the exclusion of captives from FHLBank membership. Of primary significance to captives, under the final rule the term "insurance company" excludes captive insurers, thereby making the captive insurance subsidiaries of Mortgage REITs and other entities ineligible for FHLBank membership. In clarifying its rationale for excluding the captive insurance subsidiaries of Mortgage REITs, the FHFA commented that "FHFA agrees that mortgage real estate investment trusts play an important role in the residential mortgage market. However, concluding that channeling of low-cost FHLBank funding to REITs and other ineligible entities through captive members is not authorized by or consistent with the Bank Act, FHFA is compelled to put an end to that practice until such time as Congress authorizes that access."⁵ The final rule will become effective 30 days after publication in the Federal Register.

For those captive insurers that are currently members of a FHLBank, the final rule establishes a transition period for the termination of their membership. Under the final rule, captive insurers that became members prior to publication of the Proposed Rule in September 2014 will be allowed to remain members for up to five years after the effective date of the final rule. For these members, the final rule limits outstanding advances during the five-year transition period to 40 percent of the assets of the member and prohibits new advances and renewals that mature following the expiration of the five-year transition period. However, existing advances to these members that mature beyond the transition period will be permitted to remain in place.⁶

For those captive insurers that became members after publication of the Proposed Rule, these members are required to terminate their memberships within one year following the effective date of the final rule. The final rule provides that these members have until the end of the one-year transition period (or until the date of termination, if earlier) to repay their existing advances. However, the final rule prohibits these members from taking new advances or renewing existing advances.⁷

³ See Final Rule on FHLBank Membership for Captive Insurers at 34 and 36-37.

⁴ See Final Rule on FHLBank Membership for Captive Insurers at 19.

⁵ See Federal Housing Finance Agency, Final Rule, Federal Home Loan Bank Membership, Frequently Asked Questions available at http://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FAQs-for-Final-Rule_01-12-16.pdf (Final Rule FAQs).

⁶ See Final Rule FAQs.

⁷ See Final Rule FAQs.

We welcome the opportunity to answer any questions you may have regarding these developments.

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