A Special Reprint from

The
Risk Retention
Reporter

Insurance Companies, RRGs, and the Federal Home Loan Bank System: Breaking Down the History and Benefits

Earlier this year the Federal Housing Finance Agency (FHFA) issued a final rule on membership requirements for the Federal Home Loan Bank System (FHLB System) that banned captive insurance companies from joining. Overlooked in that ruling was a carve-out for risk retention groups that not only allowed existing members to retain membership, but also left the door open for other RRGs to apply.

Much like risk retention groups, the eleven FHLBanks, which are located across the country, are structured as cooperatives. Each bank is wholly-owned by its member institutions, who are required to buy stock at their respective FHLBank upon gaining membership in the FHLB System.

The history of the FHLB System stretches back to The Great Depression when then President Herbert Hoover signed the *Federal Home Loan Bank Act* into law. The purpose of the act was to stimulate mortgage lending by creating greater access to credit for entities active in the mortgage space. Currently those entities include commercial banks, savings and loan associations (or thrifts), credit unions, certain community development financial institutions (CDFIs), and insurance companies.

Today the mission of the FHLB System is to provide members with a reliable source of funding for housing finance and community investment. Members use the funding for a variety of asset-liability management and liquidity needs—for example, an insurance company might use the funding to purchase assets or fill a cash shortfall.

Membership and Borrowing from the FHLB System

The membership process in the Bank begins with submitting a one-to-two-page application coupled with statutory reports, examinations from the state of domicile, and other information relevant to the underwriting process of each Bank in the FHLB System. Conservative underwriting is key to the FHLB System, which has never incurred a loss on an advance (loan) in its more than eight decades of existence. Thus, the application process may not be a worthwhile endeavor for newer or smaller risk retention groups. However, for larger, established risk retention groups membership in the FHLB System can provide easy access to funds at competitive rates in all economic cycles.

Once the risk retention group is granted membership they are required to buy capital stock, since like an RRG, each FHLB is owned by its member institutions. The purchase of the stock by members is proportional to their size, and each member's stock is eligible to receive a dividend. The stock would be repurchased (after a waiting period) by the Bank if the member terminated its membership. Once members buy their stock they are free to borrow from the Bank at any time. Each FHLB offers a wide-range of fixed- and variable-rate advances with different interest rates, payment characteristics, optionality, and with maturities ranging from one day to 20 years.

The FHLB System prides itself on the safety and soundness of their advances. That safety and soundness can largely be attributed to the unique advance process at the FHLB System. To begin the advance process members must pledge high quality collateral to be held by their respective FHLB custodian or by a mutually agreed upon third-party custodian. In addition to the collateralization of the loan, the member must also purchase additional capital stock from their respective FHLB in proportion to the size of the loan.

For example, if an RRG required a $15M advance with a one-month term they would initially move roughly

Recent RRG Activity in the FHLB System

Since it became official that RRGs could join the FLHB system two additional RRGs have joined: American Excess Insurance Exchange, Risk Retention Group (AEIX) and Housing Authority Risk Retention Group, Inc.

AEIX is different from many other RRGs in that it provides excess hospital liability coverage to its members, which carries larger limits. AEIX told the *Risk Retention Reporter* that membership provides the RRG with "access to a readily available, lower cost source of funds" in the event of having to resolve a large claim on short notice. This provides AEIX with the "assurance that the investment portfolio can be invested in with a long term view, since any unexpected short term cash needs can be addressed quickly and efficiently by the FHLB."

RISK RETENTION REPORTER — Published by INSURANCE COMMUNICATIONS,
P.O. Box 50147, Pasadena, California 91115. (626)796-4972, fax: (626) 796-2363; e-mail: info@rrr.com; URL - http://www.rrr.com **The *Risk Retention Reporter* is published 12 times a year. Subscription Rates: One year: $495.**

$15.5M in eligible securities to the agreed upon custodian. Once in place, the RRG would call their respective FHLB Money Desk and request the $15M advance at the current interest rate and purchase approximately $600,000 in activity stock. Shortly thereafter the FHLB would transfer $15M to the RRGs DDA account.

Once the advance matures 30 days later, the RRG would wire $15M to the FHLB for principal and pay the interest for the advance (paid monthly on a pro-rated basis). At this point the RRG can request their $600,000 in FHLB stock be repurchased or leave it in place. This activity stock would also be eligible to receive the same dividend.

Insurers and the FHLB System

Insurers have not always been significantly represented in the FHLB System. In 1999, just 39 insurers were members of the FHLB System. Now nearly 400 insurers are members. The growth in insurance company membership can be attributed to two factors. First, the FHLB has identified insurers as a key growth sector and have targeted them for membership. Second, many insurance companies are recognizing the benefits of joining the Bank.

Most of the commercial banks and credit unions eligible for membership in the FHLB System have already joined while thrifts have been in continual decline since the savings and loan crisis of the 1980s/1990s. This left insurance companies as the largest sector of potential growth for the FHLB System. Since 2000, the FHLB System has been reaching out to insurers to notify them of their eligibility to join, as many insurers were unaware of their eligibility to join.

As a result of this effort, the FHLB System has seen strong growth in insurance company membership. However, mixed in with traditional insurers were a number of single-parent captives formed by real estate investment trusts (REITS)—a type of entity currently barred from joining the FHLB System—to gain access to FHLB funds. Although these REIT captives were granted membership at the time, the trend kicked off discussion at the FHFA about amending the membership requirements for the FHLB System.

The FHFA took comments on the proposed rule over a two-year period starting in 2014, and for a while it seemed that RRGs would be banned along with other captives. However, a letter from Daniel T. Steiner, President at ICI Mutual Insurance Company, Risk Retention Group, helped turn the tide for RRG membership in the FHLB System.

At the time ICI Mutual was the only RRG with membership in FHLB System, having joined the Boston Bank in 2014. In his letter Steiner succinctly argued that RRGs, although often regulated as captives, had much in common with traditional insurance companies, particularly, since RRGs provide outside parties insurance coverage, not unlike a traditional carrier.

"ICI Mutual is not the type of 'captive' insurance company at which the Captive Prohibition is directed. Rather, as a risk retention group providing liability insurance to businesses within the American mutual fund industry, ICI Mutual is functionally equivalent to the 'traditional insurance companies' which the Proposed Rule recognizes to be eligible for Bank membership," wrote Steiner in his letter to the FHFA.

Steiner's letter was one of the major factors leading to the exclusion of RRGs from the captive prohibition in the FHLB System, and RRGs are now considered strong candidates for membership provided they are not a single parent risk retention group. Furthermore, given that both the FHLB System and RRGs are owned by their members they prioritize meeting the needs of their members in an effective and efficient manner. While there may be a short-term decline in the number of insurance companies with membership in the FHLB System as captives are phased out, the FHLB remains dedicated to growing the representation of insurance companies—including risk retention groups—in the FHLB System.

Reprinted from the October 2016 Risk Retention Reporter – Volume 30, Number 10