The CONNING COMMENTARY
STRATEGIC ISSUES FOR INSURANCE INDUSTRY EXECUTIVES

The Federal Home Loan Bank

Lender of choice to insurers?

As of year-end 2016, insurance companies had outstanding advances from the FHLB (Federal Home Loan Bank) of $102 billion. These advances were made to 168 of the 393 insurer members of the FHLB, including life-annuity, property-casualty, health insurers, and various captives. Insurer use of the FHLB has increased dramatically over the past ten years. In 2006, 50 insurers were using this facility with advances of $14.2 billion. How do insurers use the FHLB, and what are the mechanics of this widely used program?

The short answer is that advances (secured loans) from the FHLB can be structured in a variety of forms; insurer use varies by insurer type. Life insurers typically use FHLB advances to support funding agreements (policyholder contracts such as GICs), ALM activity, and investment arbitrage—investing in securities with a higher yield than the borrowing cost. For property-casualty companies, the uses are more varied, including standby liquidity facilities, working capital, and even funding of acquisitions.

What is the FHLB?

Before getting into insurer use details, we will first review the background of the FHLB for context. The FHLB is a system of eleven regional banks that lend to U.S. financial institutions to support housing finance, community lending, asset-liability management, and liquidity needs. The eleven banks are government-sponsored entities organized as privately funded cooperatives. It was originally formed in 1932 through an Act of Congress and is regulated by the Federal Housing Finance Agency. On a combined basis, the FHLB system has more than $1 trillion in assets and $52 billion in GAAP capital. The FHLB system obtains a significant portion of its financing through borrowings, which is done centrally by its Office of Finance. These borrowing obligations are joint and several obligations of the FHLB system.

As cooperatives, each of the eleven regional banks is owned by its members, with each financial institution member required to purchase stock in the respective bank. The amount of membership stock is equal to 0.40% of held mortgages, if no lending activity. There are more than 7,000 total members, which are generally limited to federally insured depository institutions, insurance companies, and Community Development Financial Institutions. FHLB describes itself as “self-funding.” As members borrow from the FHLB, they are required to purchase additional activity-based stock in proportion to their borrowings (ranging from 2.0% to 4.5% of the borrowings). Advances are also secured by pledges of high-quality collateral, typically consisting of mortgage loans and securities, U.S. government-issued or guaranteed mortgage securities, municipal securities, and other real estate-related collateral. However, corporate bonds, typically the largest asset class held by insurers, are not eligible assets for collateral.

The eleven regional banks operate somewhat independently, and requirements for collateral, amount of stock required to purchase, types of loans offered, and to whom can vary slightly by each bank. Which of the eleven regional banks an institution can use is dictated by place of business of the borrower.

FHLB advances can be structured in a wide range of loan forms, including fixed and variable rate, different payment and optionality characteristics, and with maturities ranging from overnight to 30 years. While the borrowing rate is the same for each borrower (for the same loan product), the amount of "haircut" allowed on the collateral varies. The haircut is a function of the type of collateral pledged as well as the credit-worthiness of the borrower, and haircuts range from 0% to 98%.

Insurer use of FHLB

Let's look closer at how insurers use the FHLB and who is most active in this program. First to note, all advances to insurers are made to a U.S. operating company only—not to an insurance holding company and not to nondomestic insurers. The graphs on page 7 illustrate the growth of insurer use as well as the current composition of insurer types that are FHLB members, both by amount of advances and number of companies.

When measured by number of companies, life and property-casualty companies are approximately equally represented as FHLB members. However, measured on advances, life companies had $64.9 billion outstanding, compared to only $3.4 billion for property-casualty. Surprisingly, captives accounted for $33.8 billion of the total $102 billion in advances to all insurers. Many of the captives are listed as captives of mortgage companies. We understand that, in early 2016, the FHLB discontinued membership for single-parent captives, as lending to these entities did not reflect the spirit of the FHLB program.

The graphs on page 7 are based on data from the FHLB and represent the entire universe of insurers that are FHLB members. We also have information on FHLB use by company NAIC filings, as the NAIC began tracking this information as of 2014. The two sources differ, because the NAIC does not pick up many of the captive entities.

The ten insurers with the largest amounts of collateral pledged are shown on page 7 by each type of insurer. In addition to showing collateral, also included is the collateral as a percentage of total invested assets.

A closer look at funding agreements

While all insurers that are FHLB members can borrow funds, life-annuity insurers can also issue funding agreements.

Funding agreement overview

The Stable Value Investment Association defines a funding agreement as: "An insurance contract under which the issuer guarantees principal, accumulated interest, and a future interest rate for a specified period of time. Unlike guaranteed investment contracts, funding agreements are not group annuity contracts and can be issued to entities other than tax-qualified plans."

From an insurance regulatory perspective, funding agreements are categorized as deposit-type contracts. Funding agreement owners are considered to be contract owners, similar to GIC or annuity owners, and therefore rank above other creditors in the case of insurer insolvency.

Insurers offer funding agreements most often in the form of FABS, or funding agreement-backed securities. The insurer creates a SPV (special purpose vehicle) that offers a funding agreement-backed note to institutional investors. The capital raised by the SPV from selling the note is used to purchase a single funding agreement from the insurer.

FHLB funding agreements

Life-annuity insurers use funding agreements as the method to obtain some FHLB funding. Broadly speaking, rating agencies and regulators have a positive view of FHLB funding agreements because the FHLB is seen as long-term holder of the funding agreement. As a result, FHLB funding agreements are less likely to create a liquidity crisis for an insurer.

Under statutory accounting, the insurer's use of FHLB funding determines whether the FHLB funds are considered borrowing or must be funding agreements. SSAP-15 requires that, when FHLB advances are used to support general business operations, they are required to be reported as borrowed money. SSAP-52 requires that FHLB funding used for spread lending purposes should be treated as a funding agreement and reported in the statutory financial statements as an insurance liability.

One aspect of this classification of debt versus funding agreement is that it enables us to identify how much FHLB funding is used for spread lending compared to business operations. Since 2014, statutory filings have required that insurers report the amount of outstanding FHLB borrowings they held. (The disclosure is captured in note 11B to the annual statement and includes the amount of FHLB capital stock held and the amount of collateral pledged to the FHLB. Insurers usually comment on their use of FHLB funds in note 11B.)

Borrowings are categorized as debt, funding agreements, or “other.” Our analysis of 2016 data finds that approximately 78% of outstanding FHLB funds among life-annuity insurers were funding agreements.

Rating agency/regulator perspectives

Rating agency A.M. Best has commented on the use and treatment of FHLB advances in recent rating criteria/methodology pieces—a January 2012 article on operating leverage and again in March 2013 covering holding company liquidity. In general, Best has a favorable view of insurers’ use of this access to liquidity, as the following excerpt from Best’s March 25, 2013, methodology article entitled *Analyzing Holding Company Liquidity* states: “This alternative access to liquidity generally provides insurance companies with a diversified source of funding, stopgap liquidity, support for match-funding programs and the ability to enhance yields through more robust liquidity management.”

One of the distinctions Best makes is how FHLB advances are treated, whether it is operating leverage or financial leverage. The treatment is based on what the funds are used for.

As with most programs, there is a limit to the amount of these borrowings, and Best states it “would be uncomfortable with a statutory entity or group if the sum of ISB product liabilities, retail notes outstanding, liability for securities lending FHLB loans exceeds 50% of general account ‘reserves.’”

Capital charges—no such thing as a free lunch

From an RBC perspective, FHLB capital stock has a capital charge similar to preferred stock for life insurers and common stock for property-casualty companies. For life companies, preferred stock has the same RBC charges as bonds, currently 1.1%. The pledged collateral is also subject to an RBC charge of 1.3%, which is in addition to the charge already applied to these underlying assets held by the insurer. It is this additional RBC charge on the collateral that can diminish the attractiveness of these spread programs, at least from a return on required capital perspective. As of May 2017, the Capital Adequacy (E) Task Force of the NAIC was working to refine the RBC charges associated with FHLB funding. One focus of the refinement has been on a proposal from the ACLI to reduce the 1.3% charge to 0% on the portion that serves as over-collateralization.

Is the FHLB Program for Everyone?

With a program that provides nearly immediate access to low-cost capital and liquidity and significant flexibility in how it can be structured, would any insurer want to access this program? Clearly, insurers have been a growing part of the FHLB, having grown at a much faster rate than other financial institutions. Some of the growth has been driven by a more concerted marketing effort by the FHLBs themselves, making more companies aware of the benefits and broadening the universe of eligible borrowers with flexible products. However, the FHLB program may not be desirable for companies that have an aversion to debt in any form. For others that may be too small, lack eligible collateral, or are in weak financial condition, the program may not represent an option for them.

Nevertheless, given the challenges life insurers are facing with the interest rate environment, we expect that use of the FHLB will continue to grow. We would not expect insurers to "push the envelope" with these borrowings, but anticipate more creative and expanded ways for insurers to increase their use. Insurer use increased by 18% in 2016 over 2015, as measured by collateral pledged. Growth may not be at this same rate, but we do expect continued use by life insurers in particular.

Steve Webersen, Scott D. Hawkins & Dan Erickson

Ten Largest Users of FHLB, Life Companies

As of December 31, 2016, $ in millions

Company	FHLB Borrow CY Total	Pledged Assets as Collateral to FHLB	Total Invested Assets	Percentage Borrowed of Total Invested Assets
MetLife	$15,990	$16,828	$335,244	4.8%
Aegon USA Group	5,745	7,039	84,163	6.8%
Lincoln Financial	3,350	4,821	99,846	3.4%
Principal Financial	2,751	3,314	65,079	4.2%
Sammons Financial	2,695	2,695	67,823	4.0%
Nationwide Mutual Life	2,443	2,725	53,870	4.5%
Jackson National	2,376	3,629	63,812	3.7%
New York Life	2,279	2,279	230,026	1.0%
AXA Financial	2,239	3,770	51,965	4.3%
Western & Southern Financial	2,199	2,692	34,551	6.4%

Ten Largest Users of FHLB, Property-Casualty Companies

As of December 31, 2016 in $ millions

Company	FHLB Borrow CY Total	Pledged Assets as Collateral to FHLB	Total Invested Assets	Percentage Borrowed of Total Invested Assets
AIG	$729	$1,692	$77,395	0.9%
American Family	500	671	14,543	3.4%
Liberty Mutual	400	295	59,097	0.7%
State Compensation Ins. Fund of CA	179	1,073	20,269	0.9%
Mortgage Guaranty	155	170	4,570	3.4%
State Auto Insurance Companies	137	148	3,691	3.7%
FCCI Insurance	132	141	1,574	8.4%
Hanover Insurance	125	201	6,382	2.0%
Selective Insurance	110	126	5,332	2.1%
Chesapeake Employers'	100	112	2,095	4.8%

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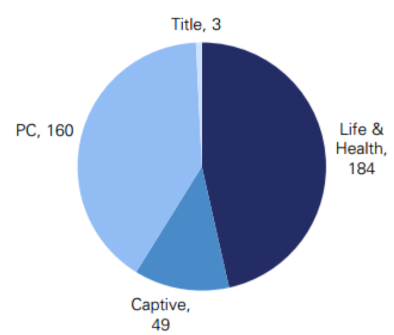
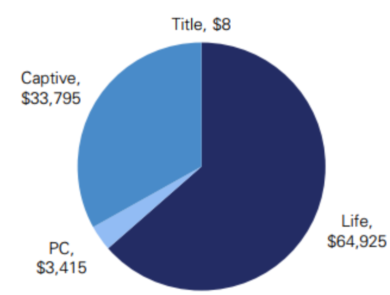
Breakout of Insurers by Type

As of December 31, 2016



Breakout of Insurers by Advances

As of June 30, 2016 in $ millions



Prepared by Conning, Inc. Source: Member list of FHLB from Federal Housing Finance Agency as of December 31, 2016

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