



FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2013 – 09

COLLATERALIZATION OF ADVANCES AND OTHER CREDIT PRODUCTS TO INSURANCE COMPANY MEMBERS

This Advisory Bulletin (AB-2013-09) applies only to the Federal Home Loan Banks (FHLBanks).

PURPOSE

This Advisory Bulletin provides guidance on credit risk management practices to ensure FHLBank advances remain fully secured when lending to insurance company members. The first line of defense to ensure repayment of an advance or other credit product is the financial health of the member, irrespective of whether the member is a depository institution or an insurance company. The second line of defense is the quality of the collateral and the extent to which the FHLBank has a first-priority security interest in the collateral.

ISSUE

The FHLBanks face risks lending to insurance companies that differ in certain respects from the risks associated with lending to federally-insured depository institutions. The different risks associated with lending to insurance companies include:

1. Insurance companies are in a different line of business from depository institutions, and their financial statements may differ from those of depositories because they generally report using Statutory Accounting Principles (SAP) instead of Generally Accepted Accounting Principles in the United States (GAAP). The procedures an FHLBank uses

to assess the creditworthiness of insurance companies must reflect the nature of their business. Any differences in reporting must be considered in analyzing an insurance company member;

2. Insurance companies are regulated principally by state authorities. While the laws governing insurance companies are generally similar from state to state, there are potentially unique features among the states regarding the regulation of insurance companies. Ultimately, the laws of the domiciliary state will control with respect to the rehabilitation or liquidation of an insurance company. Thus, it is important that each FHLBank be thoroughly familiar with the state insurance laws and regulatory framework for each state in which it has an insurance company member domiciled. The domiciliary state of an insurance company member, however, will not necessarily be within an FHLBank's district because the location of FHLBank membership is determined by an insurance company's principal place of business, which may differ from the insurance company's state of domicile. An FHLBank that has such members must be familiar with the insurance laws of the domiciliary state under whose laws those members are organized and regulated;
3. The lack of judicial consideration of whether, under the McCarran-Ferguson Act, the lien priority provision of section 10(e) of the Federal Home Loan Bank Act, as amended, would apply to security interests granted by insurance company members or would be subordinated to the state laws governing insurance companies;
4. The laws dealing with a failed insured depository institution are well known and uniform across the country; whereas, the laws dealing with the failure of an insurance company are less well known to the FHLBanks and, though similar, may vary somewhat from state to state; and
5. A potentially longer rehabilitation, liquidation, or sale process for a failed insurer, particularly a life insurance company, compared to a failed insured depository.

GUIDANCE

In assessing an FHLBank's lending to insurance companies and collateral position with insurance company members, the FHFA and its Division of Federal Home Loan Bank Regulation will evaluate, as appropriate, the following:

1. Whether the FHLBank communicates regularly with the state insurance regulator in each state where it has an insurance company member domiciled to establish an understanding of the benefits and costs associated with FHLBank membership and with respect to the prudential operations of insurance company members generally, the regulator's views on the extent to which its insurance company members may obtain advances from an FHLBank, and an FHLBank's access to collateral in the event of an insurance company liquidation or rehabilitation.

2. Whether, for each state in which an FHLBank's insurance company member is domiciled, the FHLBank has a documented, up-to-date legal analysis that addresses the state's insurance laws with respect to:
 - a. The authority of the insurance company to be a member and own FHLBank stock;
 - b. The authority of the insurance company member to enter into a secured borrowing relationship with the FHLBank;
 - c. The circumstances in which a judicial or administrative stay may be imposed in the case of a rehabilitation or liquidation of an insurance company, and the extent to which such a stay could apply to a secured creditor and its ability to liquidate an insurance company's collateral;
 - d. The circumstances in which a rehabilitator or liquidator for an insurance company may avoid transactions or agreements to which the insurance company is a party, including the length of any voidable preference period, and whether it would be possible to avoid *bona fide* extensions of secured credit made within the preference period;
 - e. Any other legal restrictions that might hinder the ability of the FHLBank to achieve "control" of collateral pledged by an insurance company; and
 - f. If the FHLBank and insurance company use a funding agreement to document an advance, whether the insurance company has the authority under applicable state law to enter into the funding agreement and to pledge collateral to support its obligations under the funding agreement, such that the FHLBank would be recognized as a secured creditor and could obtain a first-priority perfected security interest in the pledged collateral.
3. Whether in light of the legal risks described in item 2 above the FHLBank has adopted and implemented appropriate policies and procedures to manage those risks.
4. Whether the FHLBank has an established documented analytical framework and procedures for assessing periodically the creditworthiness of insurance company members using both internal and third-party sources. Whether the FHLBank's procedures differentiate insurance companies that lay off most of their exposure to a single reinsurance company and, if so, whether the FHLBank looks through to the strength of the reinsurance company.
5. Whether the FHLBank has experienced staff trained to analyze SAP and GAAP financial statements of insurance companies to assess their financial condition and creditworthiness.
6. Whether the FHLBank has evaluated and documented the methodology used to establish and update haircuts for insurance company collateral. In particular, whether the FHLBank has incorporated into its haircut analysis the possibility of being subject to a judicial or administrative stay of its right to liquidate its collateral, or the possibility that certain of its advances or collateral agreements may be voided under the state law voidable preference powers associated with insurance companies in rehabilitation or

liquidation. An FHLBank should have objective standards to measure credit quality and should be prepared to take further action, if warranted, to protect its interests in the case of default.

7. Whether the FHLBank has a written collateral liquidation policy for insurance company members and has identified resources and developed a contingency plan to liquidate the various types of collateral that it accepts from its insurance company members, if necessary.
8. Whether the FHLBank has established policies related to lending to captive insurance companies that take into account the nature and extent of their insurance activities, the source of the collateral being pledged, and whether they are affiliated with entities that are subject to regimes of “inspection and regulation” comparable to those of insured depositories or non-captive insurance companies.

Examiners will review policies, procedures, and practices when examining the FHLBanks’ collateralization of advances and other credit products. Each FHLBank should maintain documented analysis to support decisions regarding actions to perfect and control collateral.

Advisory Bulletins communicate guidance to FHFA supervision staff and the regulated entities on specific supervisory matters pertaining to the Federal Home Loan Banks, Fannie Mae, and Freddie Mac. This bulletin is effective immediately upon issuance. Contact Joseph A. McKenzie, Associate Director, Bank Analysis Branch, at Joseph.McKenzie@fhfa.gov or (202) 649-3270, Thomas Doolittle, Senior Financial Analyst, Bank Analysis Branch, at Thomas.Doolittle@fhfa.gov or (202) 649-3273, or Kari Walter, Senior Associate Director, Office of Supervision Policy at Karen.Walter@fhfa.gov or (202) 649-3405, with comments or questions pertaining to this bulletin.