Accessing the Federal Home Loan Bank for Enhanced Liquidity and Profitability

Montshire Advisors advises insurance companies in the evaluation and implementation of Federal Home Loan Bank membership and spread-based borrowing programs.

Background

The Federal Home Loan Bank ("FHLB") is a government sponsored enterprise ("GSE") formed in 1932. The fundamental business of the FHLB is to provide a readily available, low-cost source of funds in a wide range of maturities to meet the demands of its members. The FHLB can raise funds by issuing AA-rated debt and is exempt from federal, state, and local income taxes; therefore, it can lend to its members (make advances) at favorable rates and terms. The FHLB consists of eleven federally chartered and member owned wholesale banks. Each regional FHLB makes advances to its member institutions on the security of collateral pledged. Each regional FHLB is independently managed within the framework of the Federal Housing Finance Agency.

Membership

A financial institution must first become a member of a regional FHLB to be eligible to borrow (obtain an advance). Insurance companies have been eligible for membership since 1932, but membership did not become popular until regulatory changes that occurred with the passage of the Gramm-Leach-Bliley Act in 1999. Since 1999, membership and advances by insurance companies has increased exponentially.

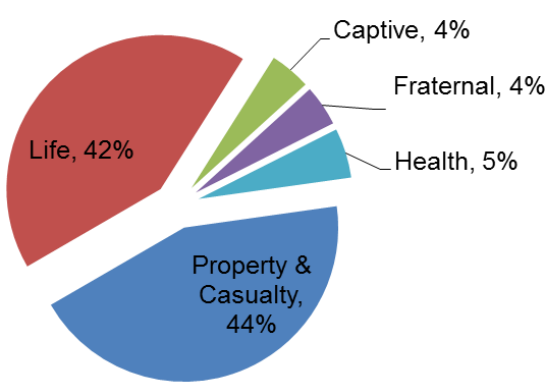
Insurance Company FHLB Membership and FHLB Advances

	2000	2005	2010	2015
Insurance Company Members	52	111	229	346
Insurance Company Advances ($B)	3	12	45	75

Source: FHLB

FHLB members include a diverse group of large and small life, property and casualty, health, and specialty insurers. The primary attraction of membership for insurers is access to flexible low cost borrowing.

Insurance Company Membership by Type



Source: FHLB

Membership Benefits

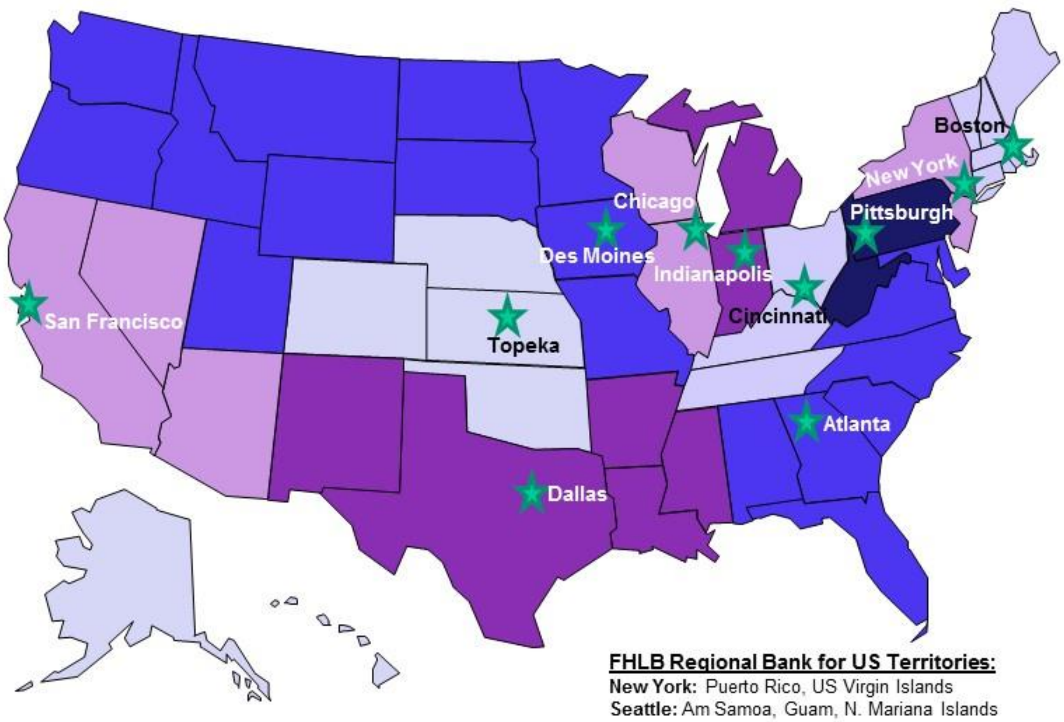
Federal home loan bank membership can provide the following benefits to insurers:

- Access to same day, flexible, and low cost borrowing.
- Ability to finance capital expenditures without liquidating earning assets.
- Increased investment income by reducing cash and short term liquidity balances and increasing invested asset balances.
- Ability to fill liability maturity gaps and manage claims-oriented liquidity events.
- Enhanced ability to manage unexpected cash flow needs.
- Increased and diversified earnings for life insurers by structuring duration matched funded institutional insurance contracts ("funding agreements") with the FHLB.
- Reduced dependency on, and cost of, maintaining other liquidity options such as lines of credit.
- Demonstrating an enhanced liquidity position to regulators and rating agencies.

Membership requirements vary by regional FHLB; however, generally the requirements are as follows:

1. The institution must be a federally or state regulated financial institution. Insurance holding companies are therefore not eligible.
2. The institution must originate or invest in residential mortgages or mortgage backed securities. Typically, 5% to 10% of the institution's assets must consist of mortgage or real estate related investments.
3. The institution must be "financially sound."
4. Generally the institution must join the regional FHLB of a region in which it is domiciled or has substantial business operations.

Eleven Federal Home Loan Bank Regions



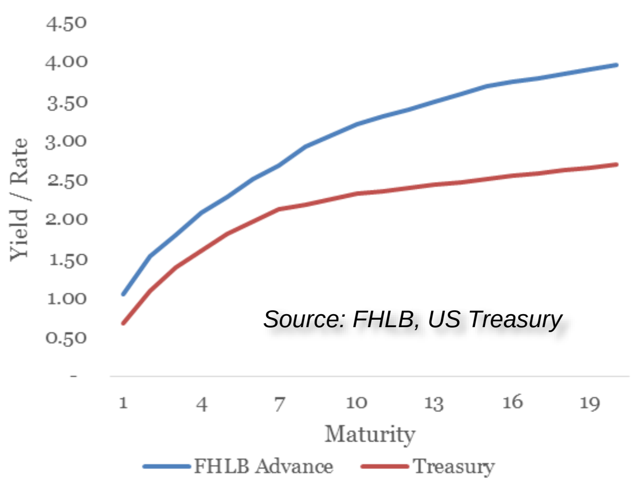
Source: FHLB

To join, the member must purchase stock in the regional FHLB. The amount of membership stock required to be purchased varies by regional FHLB. Typically the amount is equal to a certain number of basis points multiplied by either the institution's total assets (5bps to 15bps) or total mortgage related assets (20bps to 100bps).

FHLB Products

- Advances
- Advances wrapped in a "funding agreement" for life insurers
- Lines of credit
- Letters of credit
- Derivatives
- Technical / educational support

FHLB Fixed Rate Advance and Treasury Curve (December 2015)



Funding Agreements

Funding agreements are available for life insurance companies. These resemble guaranteed interest contracts in character except that with a funding agreement the member has a termination option. As with a guaranteed interest contract or annuity, the funding agreement assets are invested with a duration that matches the duration of the funding agreement liability.

More than half of the advances outstanding to insurers are in the form of funding agreements.

Advances

To borrow (obtain an advance), the member must purchase additional stock, called "activity stock" and pledge eligible collateral. The amount of activity stock required to be purchased varies by regional FHLB and typically ranges from 4% to 5% of the member's aggregate advance amount outstanding.

The member must pledge assets equal to the member's aggregate advance amount plus an applicable overcollateralization amount ("haircut"). Haircuts and eligible collateral vary by regional FHLB. Typical eligible collateral includes: US government and agency securities, mortgage backed securities, and whole mortgages.

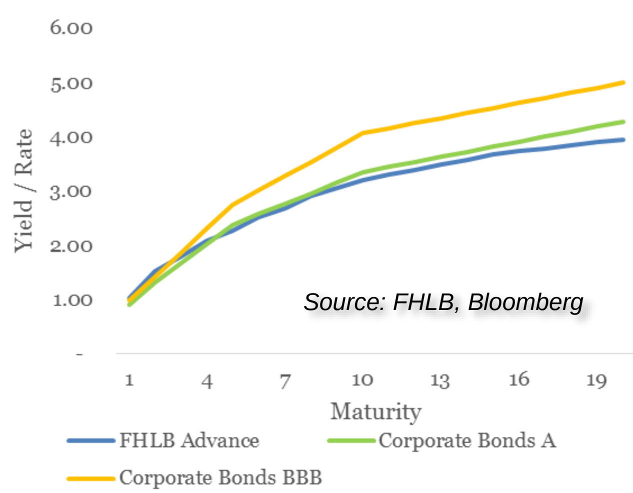
Pledged assets are still owned by, and investment income flows to, the institution member. The institution may substitute collateral at any time.

Standard types of advances include fixed-rate, variable-rate, amortizing, and convertible with maturities ranging from one day to 20 years.

Custom advances are available that include interest rate caps, floors, collars, calls or puts.

The FHLB also provides members with letters of credit and other financial products.

Corporate Bond Yields Compared with FHLB Advance Rate (December 2015)



Top 10 Insurers Total Aggregate FHLB Advances Outstanding, December 31, 2014

Insurance Group	Total Assets ($B)	FHLB Advances Outstanding ($B)	FHLB Advances, % of Total Assets
Metlife	608.35	13.57	2.2%
Aegon	209.14	2.87	1.4%
Prudential	551.62	2.23	0.4%
Lincoln Natinoal	227.55	2.18	1.0%
Jackson National	190.46	2.12	1.1%
Western & Southern	39.04	1.84	4.7%
Nationwide	136.21	1.76	1.3%
Principal	154.21	1.75	1.1%
Sammons	58.11	1.73	3.0%
Guggenheim	40.33	1.68	4.2%

Source: SNL Financial

Membership Stock Considerations

FHLB stock is nonmarketable and redeemed at par by each regional bank. Members may redeem excess activity stock or terminate membership by redeeming all of their membership stock after a notice period, which is typically five years. Historically, the FHLBs would redeem excess stock without regard to the waiting period; however currently, the Boston, Chicago, Pittsburgh, San Francisco, and Seattle regional FHLBs have ceased or limited redemption of stock in order to build capital. Each regional FHLB returns excess profits to its members in the form of dividends. Dividend rates vary by regional FHLB. Membership stock is accounted for as unaffiliated common stock on Schedule D of the statutory financial statements. Since the stock is only redeemable at par, it is not subject to market volatility.

Regional FHLB Bank Financial Summary, December 31, 2014

FHLB Regional Bank	Total Assets ($ billion)	Total Capital ($ billion)	Total Advances ($ billion)	Regulatory Capital Ratio[1]	S&P Long Term Credit Rating	S&P Outlook	Moody's Long Term Credit Rating	Moody's Outlook	Stock Dividend Rate
Atlanta	138.3	7.0	99.6	5.0%	AA+	Stable	Aaa	Stable	3.8%
Boston	55.1	2.9	33.5	6.6%	AA+	Stable	Aaa	Stable	1.5%
Chicago	71.8	4.5	32.5	6.0%	AA+	Stable	Aaa	Stable	0.9%
Cincinnati	106.6	4.9	70.4	4.7%	AA+	Stable	Aaa	Stable	4.0%
Dallas	38.0	1.9	18.9	5.1%	AA+	Stable	Aaa	Stable	0.4%
Des Moines	95.5	4.3	65.2	4.4%	AA+	Stable	Aaa	Stable	2.8%
Indianapolis	41.9	2.4	20.8	5.6%	AA+	Stable	Aaa	Stable	4.2%
New York	132.8	6.5	98.8	5.0%	AA+	Stable	Aaa	Stable	4.2%
Pittsburgh	85.7	4.0	63.4	4.5%	AA+	Stable	Aaa	Stable	3.7%
San Francisco	75.8	5.7	39.0	8.4%	AA+	Stable	Aaa	Stable	7.0%
Seattle[2]	35.1	1.2	10.3	7.6%	AA+	Stable	Aaa	Stable	0.1%
Topeka[2]	36.9	1.6	18.3	4.4%	AA+	Stable	Aaa	Stable	4.2%
Adjustments	*(0.2)*	*0.1*	-						
Total	**913.3**	**47.0**	**570.7**						

1. *Current regulations require FHLB to have a minimum capital ratio of 4%.*
2. *In 2015, Seattle and Topeka merged.*

Source: FHLB

Regulatory and Rating Agency Considerations
Due to the improvement in financial flexibility and liquidity, rating agencies generally view membership as a credit positive for insurance companies that become members and plan a conservative amount of borrowing.

The credit impact of borrowings is considered with respect to the magnitude and planned use. Borrowing excessively relative to the capital base or using proceeds in a risky manner will likely have a negative ratings implication.

Advances including those structured as funding agreements if managed with prudent asset-liability matching will generally treated as operating leverage by the rating agencies. In December 2015, AMBest published, "Draft: A.M. Best's Perspective On Operating Leverage" which indicates they view FHLB spread based borrowing programs as operating leverage and acceptable in aggregate with any other operating leverage items (e.g. GICs) up to 20% of reserves.

There are incremental rating agency and regulatory capital model risk charges associated for pledged collateral and FHLB stock. Pledged collateral typically carries an incremental charge of 0.5% to 1.3%. Purchased FHLB stock typically carries a charge that is less than the common stock asset charge. Funding agreements carry an interest rate risk charge that is typically less than the charge for fixed annuities. Additionally, asset risk charges are assessed on the proceeds of an advance to the degree they are invested.

Montshire's FHLB Advisory Services:
We provide the following advisory services to assist you in evaluating and implementing a FHLB program:
- Evaluate your eligibility and potential regional FHLB venues which could be considered.
- Estimate your current and future borrowing capacity
- Identify opportunities to replace lines of credit and other financing and estimate the potential financial benefit.
- Advise on spread-based borrowing programs, including asset classes for consideration.
- Identify FHLB insurance product integration opportunities.
- Analyze your regulatory and rating agency capital impact.
- Assist you in completing your FHLB membership process.

About Montshire Advisors
Montshire Advisors serves the insurance industry with solution oriented advisory services including FHLB program advisory services, reinsurance brokerage, capital management, alternative investment opportunities, and product and distribution opportunities. Montshire Advisors is led by its principals, Bob Alban and Ed Parry, both former insurance industry executives.