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.

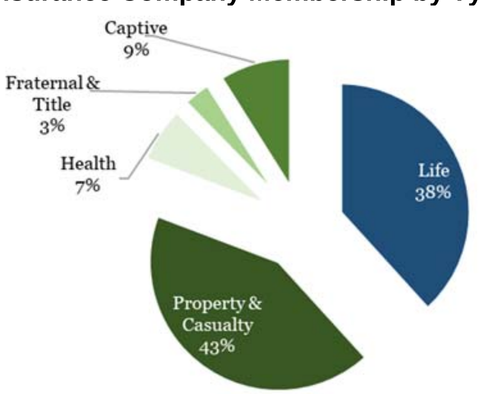
Insurance Company FHLB Membership and FHLB Advances

	2000	2005	2010	2015	2020
Insurance Company Members (#)	52	111	229	346	447
Insurance Company Advances ($B)	3	12	45	75	90

Source: FHLB and SNL Financial

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:

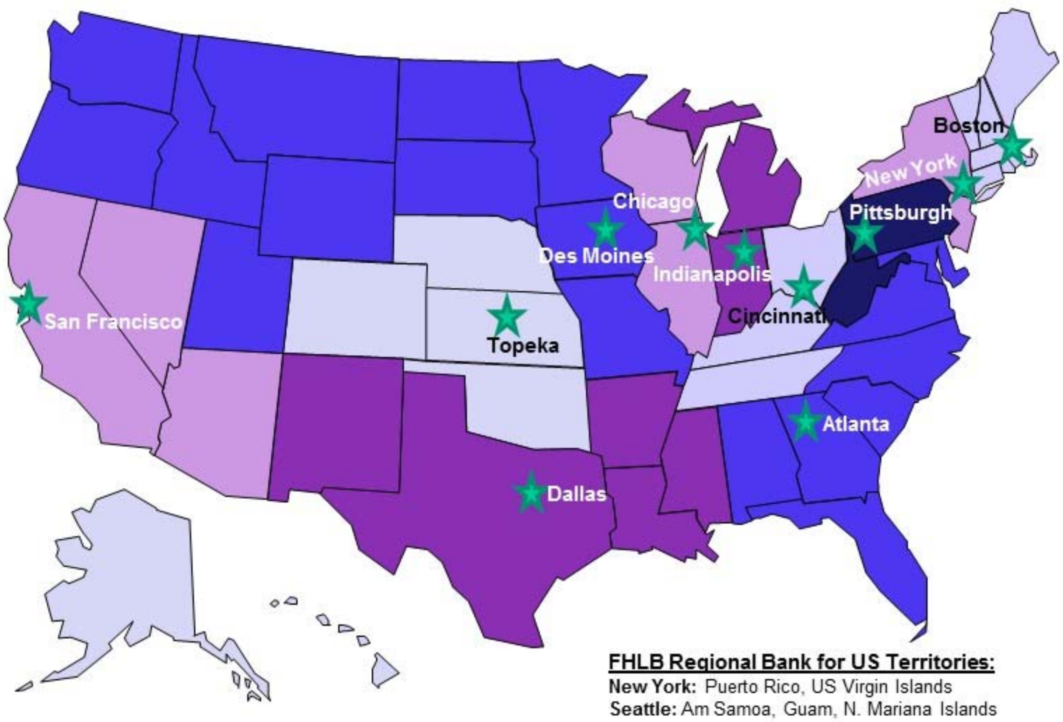
1. The institution must be a federally or state regulated financial institution. Insurance holding companies are therefore not eligible.

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



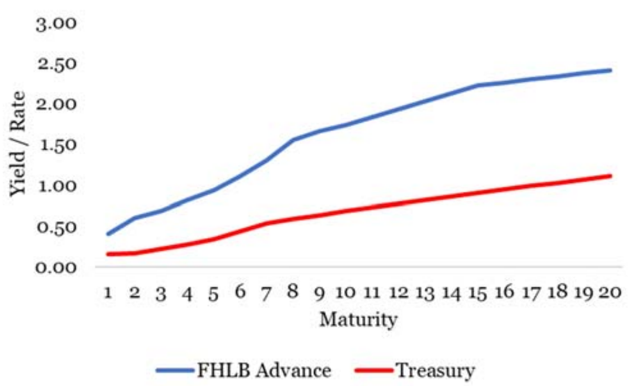
Source: FHLB

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 (May 2020)



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.

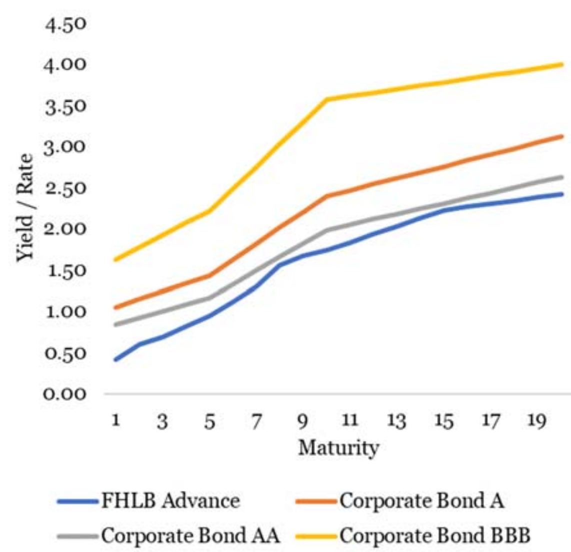
The member must pledge assets equal to the member's aggregate advance amount plus an applicable overcollateralization amount ("haircut"). Haircuts and eligible collateral vary by regional FHLB. Typical eligible collateral includes: US government and agency securities, mortgage backed securities, and 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. 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 (May 2020)



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.

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. Typically, the FHLBs will redeem excess stock without regard to the waiting period; however during periods of market distress such as following the 2008 financial crisis, some regional FHLBs 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.

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. 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.