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Opportunities at the FHLB Advance Window

by Anson J. (Jay) Glacy, Jr.

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Recent passage of the Gramm-Leach-Bliley Act increased the access that insurers have to low-cost loans (called "advances") offered by the individual banks of the Federal Home Loan Bank (FHLB) system. This article describes the general features of how advance programs work, their potential benefit to insurers and key issues that need to be considered.

About the Federal Home Loan Bank System

Congress established the Federal Home Loan Bank (FHLB) system in 1932 to enhance liquidity in the residential mortgage sector by providing a low-cost source of funds to its member institutions. As government-sponsored enterprises (GSE), the FHLB Banks are federal instrumentalities specifically authorized to carry out federal housing policy. The system comprises twelve

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Risk Management Best Practices

by David N. Ingram

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Best practice principles are well-established for risk management in banks. In addition, in the UK and Canada, best risk management practices are evolving that apply equally to banks, insurance companies and other financial services enterprises. The US life insurance industry is just beginning to talk about risk management best practices. By going last in approaching this idea, the US gets to look at the paths that have been blazed by others before choosing its course.

Risk management in banking has evolved over the past 15 years. Early in that period bank regulators expressed the strong feeling that the ad hoc approach risk management practiced in the banking business was not adequate. The business of banking was becoming more and more complex due to the steady increase of the use of derivative instruments. In addition, banks were among the losers in the junk bond market. Banks were

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regional banks, each of which is a privately owned, federally chartered corporation with specialized lending powers. The charters of the banks also give them special benefits, like exemption from registering their securities with the Securities and Exchange Commission and exemption from state and federal taxation (apart from statutorily mandated REFCorp obligations). Most important the implicit credit guarantee of the federal government permits the banks to borrow at rates comparable to U.S. Treasury obligations and thereby make advances to their own borrowers at highly attractive rates.

Benefits of FHLB Advances

FHLB advances, in the forms of fixed- and adjustable-rate loans, can help qualifying members in a number of ways:

- As a ready source of liquidity;
- To lower overall cost of funds;
- To grow the balance sheet;
- To manage their interest-rate risk profile; and
- To enhance investment income.

For insurers, the liquidity benefits of FHLB advances can:

- Lessen dependence on existing liquidity facilities;
- Reduce cash balances and permit them to be more fully invested;
- Help insurers more confidently manage transient cash flow dislocations;
- Provide liquidity that enables investment in less liquid but higher yielding assets; and
- Permit extension on the yield curve with commensurate yield pick-up.

For annuity writers in particular, FHLB advances can be an attractive and capital-friendly source of funds.

Dimensions of the Program

While utilization levels vary widely among members, the average outstanding advance as of December 31, 2000 was about 7.5% of assets. System-wide, FHLB advances to members totaled $473 billion at December 31, 2001, having grown at a 24% annual rate since 1995. Collectively, FHLB banks comprise the third-largest U.S. financial institution, behind Fannie Mae and JPMorgan Chase.

> ‘the FHLB banks are Federal instrumentalities specifically authorized to carry out federal housing policy.’

As of December 31, 2001, 57 insurance companies had joined and 31 were active borrowers. These 31 borrowers accounted for $3.1 billion in outstanding advances.

Membership Requirements

Only duly regulated companies subject to U.S. law and regulations can become FHLB members. These include insurance companies, banks, thrifts and credit unions. Only an insurance entity that files a statutory statement with its governing state insurance regulator can make an application for membership. Application cannot be made at the holding-company level. While each bank manages its advance program differently, a candidate insurer generally must demonstrate a sound financial record in order to join its regional FHLB Bank. The candidate may need to exhibit favorable profitability trends and/or possess sufficient capital strength.

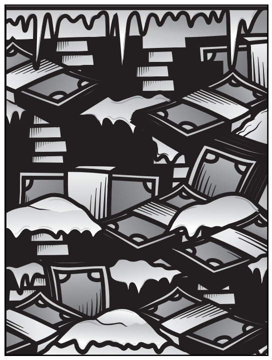
To access FHLB advances, a member must first purchase FHLB bank stock in the amount of 1% of its residential mortgage loans and then pledge high-quality mortgage or other real estate-related assets as collateral for the desired advance. While available collateral will dictate the limit on the borrowing capacity possible, the FHLB bank will ultimately determine the maximum term and amount of any advance it decides to extend to a particular member. Currently, borrowing members must hold FHLB stock of at least five percent of outstanding advances or 1% of its residential mortgage loans, although Gramm-Leach-Bliley-mandated recapitalization requirements among the banks may liberalize this requirement. For example, proposals under consideration may reduce the amount of FHLB stock required for membership from the 1% level to as little as 0.2%, depending upon the particular Bank.

Most banks, upon request, will provide a helpful package containing forms for membership application and instructions for computing the required amount of FHLB capital stock that must be purchased and the borrowing limit. In addition, the package may include a draft Board of Directors resolution and other legal documents. A number of the banks have customized these forms for use by insurance companies. Typically, a two- to eight-week period transpires from date of bank membership application to ultimate disbursal of advance funds. Once funds have been advanced, the banks will require collateral and financial reporting on a regular basis.

Characteristics of FHLB Common Stock

Each FHLB bank issues its own shares of common stock. These are classified by the NAIC as unaffiliated common stock on Schedule D of the statutory statement. The shares are non-marketable and can only be redeemed at par by the bank. Each bank sets its own dividend scale. Dividend rates on FHLB stock historically have averaged between 5% and 8%, depending on the particular bank. Currently, five banks pay stock dividends and the remaining seven banks pay cash dividends. For insurers, stock dividends are recorded as increases in ownership on the statutory statement.

Under Gramm-Leach-Bliley-mandated recapitalization requirements, banks are changing the structure of their common stock in order to establish a more permanent and modern capital structure. For some banks, common stock will be redeemable only upon giving five years notice to the bank. However, banks are expected to redeem stock that becomes "excess" as a result of a decrease in a member's total assets or as a result of normal repayment or prepayment of advances. As of this writing (April 1, 2002), only the Seattle Bank had had its recapitalization plan approved by the Federal Housing Finance Board.



Structure of Advances

Each bank offers and manages its own brand-name program of advance products. Banks customize advances to meet the specific financing needs of members using a variety of interest conventions and cash flow and amortization schedules. Some banks can also embed a variety of derivative-like features (like rate caps) into the advance structure. Floating-rate advance rates typically approximate LIBOR (the London Interbank Offered Rate, which is the rate most major international banks dealing in Eurodollar currency charge each other for large loans). Advances at other maturity points can be obtained, depending on the particular objectives of the member. Advances are usually prepayable, subject to a prepayment penalty that compensates the bank for economic and back-office costs involved.

Pricing of Advances

FHLB banks raise money by selling debt securities to institutional investors, like insurance companies. These bonds are rated Aaa/AAA by Moody's and Standard & Poor's, respectively. Their ratings enable the banks to issue debt at just slightly higher rates than Treasury bonds. The FHLB Office of Finance acts as the central debt issuance facility for all 12 banks. The banks then advance funds to member institutions at lower rates than available in the commercial market and at small spreads over comparable Treasury instruments. For example, on the afternoon of April 1, 2002 the Bank of Des Moines offered a LIBOR-based floating advance at 2.22%, 19 basis points above three-month LIBOR and 43 basis points above the comparable Treasury bill rate. At the five-year point on the curve, advances from the Des Moines Bank have been priced at an average 58 basis points above Treasuries over the past 10 years.

Banks also offer members a variety of discounts from "standard" rates. These range from lower rates on jumbo advances to preferential pricing to institutions that participate in local community investment programs. Some banks offer discounts for seemingly eccentric reasons, such as "mid-week specials."

RBC Treatment

Currently, FHLB common stock held by life and health insurers is treated like Class 1 Preferred Stock for RBC purposes. Insurers usually record the liability for an FHLB advance as borrowed money in the statutory statement. Alternatively, the advance can be considered to be a deposit structured in the form of a funding agreement and recorded in insurance liabilities.

Currently, borrowed money receives no RBC charge while a funding agreement would follow the treatment for deferred annuities and GICs.

Considerations for Insurers

Regulator Receptivity - Research indicates that most regulators are unfamiliar with the issues surrounding FHLB advances due to their recent advent. One key issue that has arisen relates to standing of the advance. Some banks' standard membership applications require that a full lien against pledged collateral be assigned to the bank. Some insurance regulators have found this to be unacceptable when funding agreements are employed as advance vehicles. These regulators have sought modification to legal documents stating that the bank has no legal rights as a policyholder.

Crowding Out - Insurance investment law varies by jurisdiction and between life and health and property and casualty companies. Insurers with substantial advance positions may find themselves growing out of their equity baskets. This may either restrict investing latitude for companies contemplating positions in other common stock or limit the amount of their desired FHLB advance position.

Custody - The 12 district banks have differing views on the custody of pledged collateral. They range from all collateral being pledged at the bank's custodian to a simple line entry on the member's books. These rules may vary depending upon the financial strength of the particular member.

Separate Accounts - Companies with substantial variable annuity and life business lines may find themselves in a disadvantageous FHLB advance position. For membership purposes, the typical one-percent-of-assets requirement including separate account assets may constitute an unacceptably large commitment to FHLB stock. At the same time, such companies might want these assets considered for determination of eligible collateral (irrespective of the custody issues that may be involved). FHLB banks and the governing Federal Housing Finance Board are currently addressing this issue.

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