NAIC National Association of Insurance Commissioners & The CENTER for INSURANCE POLICY and RESEARCH **Capital Markets Special Report**

The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

# U.S. Insurer Exposure to the FHLB System as of Year-End 2016

This special report is an update of the NAIC Capital Markets Bureau Special Report, "U.S. Insurer Exposure to the Federal Home Loan Banking System as of Year-End 2015," published Sept. 13, 2016. The previously published report discussed the purpose and structure of the Federal Home Loan Bank (FHLB) system, and it concluded with an analysis of U.S. insurer exposure to FHLB borrowings (advances), debt and capital stock.

For any insurer to borrow from an FHLB, they must be a member of the specific FHLB, which requires them to hold both member and activity stock. This is regardless of how the borrowing is treated by either the FHLB or the insurer; i.e., as an advance, as debt or as a funding agreement. All such capital stock is treated as common stock by insurers. Given the connection between the two activities, the requirements regarding disclosure of borrowings are included in *Statement of Statutory Accounting Principles (SSAP) No. 30—Unaffiliated Common Stock*.

According to SSAP No. 30, U.S. insurers shall disclose the aggregate amount of their borrowings from the FHLB, reflecting a compilation of all advances, loans, funding agreements, repurchase agreements, securities lending, etc., that they have outstanding with the FHLB. This disclosure is required for outstanding advances at the reporting date and the maximum amount of aggregate borrowings from an FHLB at any time during the current reporting period.

In this report, our analysis focuses on U.S. insurer exposure to FHLB capital stock and FHLB bonds at year-end 2016, as well as the maximum amount of FHLB borrowings by U.S. insurers throughout 2016.

**U.S. Insurer FHLB Advances and Pledged Collateral**

FHLB advances are a stable source of low-cost funding with maturities that can vary from short-term to up to 30 years based on the needs of the U.S. insurer. Prepayment of outstanding advances prior to the stated maturity may not be permitted or, if permitted, result in significant penalties. Advances can be structured in different forms, and are generally reflected as debt or, for life companies (those that are licensed to issue deposit-type contracts), funding agreements. Funding agreements are mainly reported by life companies, as there are very few, if any, property/casualty (P/C) companies licensed to issue such products.

Furthermore, whether advances are classified as debt or funding agreements depends on the intended use. Advances that are used for financial leverage (spread investment) are reported as funding agreements; if used to fund general business operations, they are reported as debt.

According to *SSAP No. 15—Debt and Holding Company Obligations* and *SSAP No. 52—Deposit-Type Contracts*, advances from an FHLB shall be evaluated on an individual basis and shall be accounted for in accordance with the substance of the individual agreement. If the arrangement is, in substance, a funding agreement, it would be accounted for under SSAP No. 52 with established policy reserves for all contractual obligations arising from the contract provisions.

Regardless of whether the advance from the FHLB is considered "debt" or a "funding agreement," U.S. insurers must disclose identical information on FHLB activity, including information on FHLB common stock held (because they can only borrow if they own FHLB stock), collateral pledged to the FHLB, advances from the FHLB and whether advances are subject to prepayment penalties.

U.S. insurers reported about $70 billion in FHLB advances outstanding as of year-end 2016 and *maximum* advances totaling $81 billion in FHLB during 2016, with the $11 billion difference due to 84 insurers that reported a difference between their maximum borrowings for 2016 and the outstanding amount at year-end. In comparison, insurers reported maximum advances of $48.8 billion in 2015.

The 68% increase in FHLB maximum advances from 2015 to 2016 was mainly driven by 36 insurers reporting $20.9 billion in maximum advances in 2016 but not in 2015 (which includes insurers as new FHLB members in 2016, as well as others that had zero borrowings during the year).The disclosed value of FHLB maximum advances in 2016 represented 34% of the estimated borrowing capacity disclosed by insurers.

The vast majority of FHLB advances to U.S. insurers (91%) were to life companies. Per the statutory financial statements for year-end 2016, only 165 of the 310 insurer FHLB members reported having an FHLB advance during the reporting period. Of those that reported these advances, 95 were life companies, 51 were P/C companies and 16 were health companies.

The large disparity in the number and the outstanding amount of advances between life companies and P/C companies is explained by each industry's purpose in obtaining advances: life companies mainly use advances as part of their spread business, whereas P/C companies without deposit-type contracts see value in FHLB membership because it provides access to readily available liquidity.

Insurers with total cash and invested assets greater than $10 billion accounted for 83% (or $67.6 billion) of FHLB maximum aggregate advances in 2016, as shown in Table 1; life companies accounted for about $65.5 billion of this total.

**Table 1: U.S. Insurer Year-End 2016 FHLB Maximum Advances by Total Cash and Invested Assets ($mil. BACV)**

| Insurer Type | Less Than $250mm | Between $250mm and $500mm | Between $500mm and $1B | Between $1B and $2.5B | Between $2.5B and $5B | Between $5B and $10B | Greater than $10B | Total |
|---|---|---|---|---|---|---|---|---|
| Fraternal | - | 43 | - | - | - | - | 125 | 168 |
| Life | 211 | 5 | 641 | 931 | 2,424 | 4,139 | 65,487 | 73,838 |
| P/C | 65 | 75 | 239 | 833 | 466 | 296 | 1,972 | 3,947 |
| Title | 4 | - | - | - | - | - | - | 4 |
| Health | - | - | 230 | 781 | 25 | 2,057 | - | 3,093 |
| Total | 280 | 123 | 1,110 | 2,545 | 2,916 | 6,492 | 67,584 | 81,050 |
| Pct of Total | 0% | 0% | 1% | 3% | 4% | 8% | 83% | 100% |

*SSAP No. 1—Disclosure of Accounting Policies, Risks and Uncertainties, and Other Disclosures* requires U.S. insurers to disclose amounts that are reported in the financial statements but that are "restricted" because they are pledged as collateral or under the exclusive control of the insurer. FHLB capital stock held and assets that are pledged as collateral to an FHLB are considered restricted assets subject to this disclosure.

In addition, under SSAP No. 30, insurers must disclose FHLB capital stock that is eligible for redemption and the anticipated redemption time frame. Note that FHLB capital stock can only be redeemed with the FHLB after written notification on the intent to redeem and after a specified waiting period. Class B stock has a five-year waiting period after submitting written notification to redeem.

In the Notes to the Financial Statements(Note 11 – Debt), U.S. insurers reported assets pledged as collateral to the FHLB system with a book/adjusted carrying value (BACV) of $96.2 billion at year-end 2016, up from $73 billion as of year-end 2015 (see Table 2). Each FHLB member must pledge collateral to receive advances, and the fair value of pledged collateral is required to exceed the amount of the FHLB advance. The value allowed in the calculation also varies depending on the quality and liquidity of the asset.

This overcollateralization provides the FHLB with additional cushion in the event of a member default. FHLB members may also pledge collateral in anticipation of FHLB advances to minimize any delay in accessing the liquidity. As such, the $23 billion increase in pledged collateral from 2015 to 2016 is for existing advances, as well as for the intention of maintaining an open but undrawn liquidity source, which includes any potential overall overcollateralization. Subtracting the BACV of pledged collateral that was reported at year-end 2016 for U.S. insurers that did not report advances for that year, total pledged collateral to FHLB by U.S. insurers would be approximately $94 billion.

In 2014, the FHLB system issued proposed rules where the definition of "insurance company" would exclude captive insurers, thereby preventing entities—such as real estate investment trusts (REITs)—that do not otherwise meet the statutory requirements from becoming FHLB members. The FHLB rule published in January 2016 by the Federal Housing Finance Authority relative to FHLB membership set a FHLB member termination date of Feb. 19, 2017, for captive insurers that became members after Sept. 12, 2014.

For captive insurers granted FHLB membership prior to Sept. 12, 2014, the FHLB member termination date is February 2021. Thus, some captive insurers of REITs had the ability to request advances in 2016, as FHLB membership following the January 2016 rule was not terminated for all captive insurers.

**Table 2: U.S. Insurer Year-End 2016 FHLB Pledged Collateral ($mil.)**

| Insurer Type | BACV | Pct of Total |
|---:|---:|---:|
| Fraternal | 342 | 0% |
| Life | 86,409 | 90% |
| P/C | 6,947 | 7% |
| Title | 5 | 0% |
| Health | 2,472 | 3% |
| Total | 96,175 | 100% |

**U.S. Insurer Exposure to FHLB Capital Stock**

U.S. insurers reported holdings of FHLB capital stock with a par value of $4 billion in 2016, up slightly from $3.6 billion in 2015 (see Table 3). FHLB capital stock is reported at par value in the statutory financial statements, and it is only redeemable with the FHLB at par. FHLB capital stock is not traded on the open market; therefore, it is not subject to market value risk. The risk-based capital (RBC) charge for FHLB capital stock is the same for life companies and P/C companies, at 1.1%.

Life insurers, as the largest FHLB borrowers, are also the largest holders of FHLB capital stock (across the five major insurer types), accounting for 90% of reported year-end 2016 holdings. U.S. insurer capital stock holdings consisted of activity-based stock ($2.6 billion), Class A stock ($113 million), Class B stock ($1.2 billion) and excess capital stock ($75 million).

The amount of activity-based stock held is a determinant of the amount of advances that an FHLB member can take. Excess capital stock is any amount held that is greater than required under the particular district bank capital requirement. For example, if additional capital stock was acquired to receive an advance, and the insurer repaid the advance, the additional capital stock held would be classified as excess stock.

If an insurer decides to redeem its member stock, the FHLB may repurchase such member stock investments that exceed the required minimum amount if it is in compliance with regulatory capital requirements and will maintain such compliance after the repurchase.

**Table 3: U.S. Insurer Year-End 2015 Exposure to FHLB Capital Stock ($mil.)**

| Insurer Type | Capital Stock | Pct of Total |
|---:|---:|---:|
| Life | 3,588 | 90% |
| P/C | 288 | 7% |
| Health | 118 | 3% |
| Fraternal | 6 | 0% |
| Title | 0 | 0% |
| Total | 3,999 | 100.0% |

Large life companies (greater than $10 billion in total cash and invested assets) held $3.1 billion of the $3.6 billion of FHLB capital stock held by all life companies, as shown in Table 4. Large insurers across all insurer types accounted for about $3.3 billion (or 82%) of total U.S. insurer exposure to FHLB capital stock (see Table 4).

**Table 4: U.S. Insurer Year-End 2016 Exposure to FHLB Capital Stock by Total Cash and Invested Assets ($mil. BACV)**

| Insurer Type | Less Than $250mm | Between $250mm and $500mm | Between $500mm and $1B | Between $1B and $2.5B | Between $2.5B and $5B | Between $5B and $10B | Greater than $10B | Total | Pct of Total |
|---:|---:|---:|---:|---:|---:|---:|---:|---:|---:|
| Life | 11 | 3 | 34 | 48 | 140 | 228 | 3,124 | 3,588 | 90% |
| P/C | 8 | 8 | 23 | 69 | 19 | 21 | 140 | 288 | 7% |
| Health | 0 | - | 10 | 48 | 0 | 59 | - | 118 | 3% |
| Frateranl | 0 | 2 | 0 | 0 | - | - | 3 | 6 | 0% |
| Title | 0 | - | - | - | - | - | - | 0 | 0% |
| Total | 19 | 12 | 67 | 166 | 159 | 309 | 3,267 | 3,999 | 100% |
| Pct of Total | 0% | 0% | 2% | 4% | 4% | 8% | 82% | 100% | |

## U.S. Insurer Exposure to FHLB Bonds

In addition to advances and capital stock holdings, U.S. insurers also invest in bonds issued by the FHLB system. U.S. insurers reported exposure to FHLB bonds with a BACV of $9.8 billion as of year-end 2016, down from $11.1 billion in 2015, and a 12% decrease from 2014 ($12.7 billion).

While both FHLB and insurer assets under management have been growing year over year, insurer holdings of FHLB bonds decreased from 2015 to 2016, likely because of their lower yield compared to other, higher yielding investment opportunities. Life and P/C insurers held about 85% of the industry's FHLB bonds at year-end 2016 (see Table 5). In general, there was no significant change in FHLB bonds held by each of the five major insurer types year-over-year from 2014 to 2016 (in percentage terms).

**Table 5: U.S. Insurer Year-End 2016 Exposure to FHLB Bonds ($mil.)**

| Insurer Type | YE2016 BACV | Pct of Total | YE2015 BACV | Pct of Total | YE2014 BACV | Pct of Total |
|---:|---:|---:|---:|---:|---:|---:|
| Life | 4,344 | 44% | 4,519 | 41% | 5,314 | 42% |
| P/C | 3,988 | 41% | 5,036 | 45% | 5,817 | 46% |
| Health | 1,209 | 12% | 1,272 | 11% | 1,263 | 10% |
| Fraternal | 231 | 2% | 266 | 2% | 316 | 2% |
| Title | 15 | 0% | 22 | 0% | 20 | 0% |
| Total | 9,787 | | 11,116 | | 12,729 | |

U.S. insurers with total cash and invested assets greater than $10 billion comprised 39% of insurers' reported exposure to FHLB bonds (in terms of BACV) at year-end 2016. U.S. insurers with between $1 billion and $2.5 billion total cash and invested assets under management accounted for 16% of FHLB bond exposure, followed by insurers with less than $250 million total cash and invested assets, and insurers with between $500 million and $1 billion total cash and invested assets under management, accounting for 12% and 10%, respectively (see Table 6).

**Table 6: U.S. Insurer Year-End 2016 Exposure to FHLB Bonds by Total Cash and Invested Assets ($mil.)**

| Insurer Type | Less Than $250mm | Between $250mm and $500mm | Between $500mm and $1B | Between $1B and $2.5B | Between $2.5B and $5B | Between $5B and $10B | Greater Than $10B | Total | Pct of Total |
|---|---|---|---|---|---|---|---|---|---|
| Life | 138 | 58 | 261 | 262 | 351 | 327 | 2,948 | 4,344 | 44% |
| P/C | 722 | 469 | 646 | 814 | 158 | 379 | 800 | 3,988 | 41% |
| Health | 306 | 164 | 73 | 432 | 146 | 88 | - | 1,209 | 12% |
| Fraternal | 16 | 19 | 3 | 37 | 41 | - | 114 | 231 | 2% |
| Title | 2 | - | - | 14 | - | - | - | 15 | 0% |
| | 1,184 | 709 | 983 | 1,559 | 696 | 794 | 3,862 | 9,787 | 100% |
| Total (%) | 12% | 7% | 10% | 16% | 7% | 8% | 39% | 100% | |

The distribution of FHLB bond maturities (with respect to those held by U.S. insurers) was tilted toward the long end, with 55% of bonds having maturities of greater than five years, up from 50% in 2015. In comparison, about 96% of total FHLB bonds outstanding mature within five years or less. FHLB bonds held by life and fraternal insurers were even more weighted toward longer-dated bonds: 73% and 75% of their exposures, respectively, had maturities greater than 10 years. The difference in the concentration of maturities across insurer types is a function of asset-liability matching. Almost all of the FHLB bonds held by health companies mature in 10 years or less (see Table 7).

**Table 7: U.S. Insurer Year-End 2016 Exposure to FHLB Bonds by Maturity**

| Insurer Type | Less than 1yr | 1yr to 5yrs | 6yrs to 10yrs | 11yrs to 20yrs | Greater Than 20yrs |
|---|---|---|---|---|---|
| Life | 14% | 7% | 6% | 67% | 6% |
| P/C | 26% | 41% | 19% | 15% | 0% |
| Health | 27% | 46% | 26% | 1% | 0% |
| Fraternal | 7% | 12% | 6% | 74% | 1% |
| Title | 25% | 6% | 9% | 60% | 0% |
| Total | 20% | 25% | 14% | 38% | 3% |

## Summary

The FHLB system provides residential mortgage liquidity through direct purchases or by facilitating (as agent) third-party sales of mortgage loans from members. The FHLB system also provides members with advances collateralized by assets pledged by the insurer.

U.S. insurers reported FHLB maximum advances of $81 billion during 2016, the majority of which (91%) were to life companies. Among the five insurer types, life companies also had the largest exposure to FHLB capital stock, with a BACV of $3.6 billion out of the $4 billion reported at year-end 2016. The majority of U.S. insurer capital stock exposure consisted of activity-based stock ($2.6 billion).

Due, in part, to the restriction limiting the sale of FHLB capital stock to only FHLB at par and the six-month and five-year notification requirement for redemption of Class A and Class B capital stock, respectively, FHLB capital stock is relatively illiquid.

FHLB bonds are not guaranteed by the full faith and credit of the U.S. government as to the payment of interest and principal, as the FHLB system is a government-sponsored entity (GSE) that receives indirect governmental support (and is not a government agency). All of the bonds are, however, the joint and several obligations of all 11 banks comprising the FHLB system. The FHLB system does benefit from capital markets access at lower rates than would be available without federal government support. The likelihood of loss to U.S. insurers from FHLB default on its debt is minimal, given the FHLB status as a GSE and given U.S. insurer exposure to FHLB bonds ($9.8 billion) accounted for less than 1% of the U.S. insurance industry's total cash and invested assets, which is the same exposure U.S. insurers have to Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) bonds.

The Capital Markets Bureau will continue to monitor trends in exposure to FHLB and report on any developments as deemed appropriate.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.