

Executive Summary
Revisions to Stay and Preference Provisions
of the State Insolvency Statutes Governing Insurance Companies

I. Purpose of the Draft Language

Provide Federal Home Loan Bank (FHLBank)¹ insurance company (IC) members more options in managing liquidity and funding when using their FHLBank.

Equalize treatment for FHLBank lending to ICs regulated under state insolvency statutes with FHLBank lending to FDIC insured depository institutions (IDIs) governed by federal banking law, the Federal Deposit Insurance Act (FDIA)².

The proposed revision will not affect Section 711 of IRMA dealing with qualified financial contracts (QFCs).

Under current practice, ICs who borrow from FHLBanks (such loans are referred to as “advances”) generally do so at less attractive terms than do IDI members including a narrower range of collateral, additional collateral required to overcollateralize IC member loans from the FHLBanks, and the terms by which that collateral is secured. An important yet less liquid IC asset that could be pledged, commercial real estate, is particularly impacted by this issue.

Increasing regulatory attention on FHLBank lending to ICs could have a chilling effect on this important source of liquidity going forward. The disparate statutory treatment of FHLBank lending to ICs as opposed to IDIs is a central element of this attention.

Without commensurate protections at the state level, as FHLBanks maintain their 80-year “no loss on an advance” track record when lending to IC members, the FHLBanks must manage the additional incremental risk they face as opposed to lending to IDIs. This occurs in various ways such as: IC loan limits; limits on the types of eligible collateral (for example, only accepting securities collateral); and higher discounts on pledged collateral, meaning more of the most liquid IC assets must be deployed to secure FHLBank liquidity.

Under current law, an IC FHLBank member of the same credit quality as an FHLBank IDI member is subject to more stringent collateral practices and terms.

The success of this effort will have a positive impact on the liquidity management of insurance companies and will not have a material impact on guaranty associations.

¹ The 12 regional FHLBanks are congressionally chartered, federally regulated wholesale banks that jointly and severally issue debt in global capital markets at attractive rates to provide a steady stream of low-cost funds to 8,000 member/owner financial institutions throughout the nation.

² 12 U.S.C. 1821(d)(5)(D)(iii) and (e)(14).

II. Description of the Draft Language

The draft language:

- Provides that the FHLBanks are not subject to a stay or prohibited from exercising their rights to collateral pledged to them by an IC borrower who becomes subject to an insolvency proceeding. The FHLBanks expect to pursue the legislative change on a state basis and are not seeking to revise the Model Act. Solely for illustrative purposes, attached is an example of draft language to be used in the applicable provision of each state's insolvency statute.
- The proposed language excludes the FHLBanks from the voidable preference provision of the insolvency statute. See attached illustrative draft language.
- While analogous to the exemption from the stay and preference provisions provided to QFC counterparties as adopted by various states in their respective insolvency statutes, the proposed revision is not directed at netting or QFC provisions and does not affect Section 711 of IRMA.
- Would not extend the exemptions beyond the FHLBanks to other secured creditors. The proposed revision is drafted narrowly to parallel the unique protections the FHLBanks have under federal law.
- Will not have a material impact on the assets available to a liquidator in the event of the failure of an insurance company that has borrowed from an FHLBank. In fact, the legislation should benefit the rehabilitator in a number of ways that should reduce the overall costs of a resolution (including any ultimate liquidation) including:
 - allowing lending to ICs generally with less onerous collateral requirements (including the overcollateralization requirements) than currently applied could leave more assets available to the rehabilitator in the event of an IC failure.
 - With the state insurance regulator's approval, increasing the possibility of continued/additional FHLBank lending to the IC during a rehabilitation process;
 - Increasing the options in transferring existing FHLBank funding to the IC to the acquirer of operations of the failed IC; and
- Has been recognized as beneficial to life insurance company members and is supported by the American Council of Life Insurers.

III. Strengthening Insurance Companies

This legislation would improve insurance company funding opportunities, enhancing their asset-liability management by:

- (1) Offering the opportunity for FHLBanks to expand the types of collateral insurance companies can pledge to the FHLBank;
- (2) Potentially reducing collateral burdens (such as the level of overcollateralization) and reporting burdens on insurance company members;

- (3) Reducing the level of overcollateralization and the expansion of eligible collateral to be pledged to the FHLBank reduces the amount of more liquid Treasury and Agency securities collateral that is subject to pledge freeing these securities for use by IC members elsewhere;
- (4) Enabling FHLBank IC members to obtain additional value by pledging less liquid assets (such as commercial real estate loans) to the FHLBank as collateral for advances; and
- (5) Continuing FHLBank lending during periods of industry challenges (where and to the extent the state insurance regulator agrees such lending is prudent).

The ACLI March 2011 comment letter on the FHFA ANPR made the following points about the benefits of FHLBank lending to ICs:

- Access to FHLBank funds aided insurance company members in navigating through the credit crisis.
- Insurance companies rely on FHLBank products for contingent liquidity planning, managing high impact liquidity events, and reducing risk through enhanced asset liability management.
- As recognized by ICs in their SEC filings, diversity of funding sources enhances funding flexibility, limits dependence on any one market or source of funds and generally lowers the cost of funds.

A 2011 AM Best Presentation³ noted the following FHLBank funding benefits:

- Managing catastrophic liquidity events (confidently managing unexpected cash flow dislocations & catastrophic liquidity events)
- Increasing earnings through more aggressive liquidity management
- Increasing operational leverage and earnings through matched trades
- Filling liability maturity gaps up to 30 years
- Financing special projects, such as new facilities, without liquidating earning assets
- Utilizing letters of credit to improve risk-based capital
- Same-day access to low-cost funds
- Products with flexible terms
- No regulatory filings to access capital
- Can be structured as deposit-type contracts or borrowings

³2011 FHLBank of Indianapolis Insurance Lending Conference

How an IC uses its borrowed funds is key to maintaining the health of that company. A less expensive, more stable and manageable source of funds, such as FHLBank advances, will provide important asset liability management tools for ICs.

IV. Effect on Insurance Company Rehabilitators and State Guaranty Associations

Unlike other creditors of ICs, FHLBanks operate as cooperatives under tight federal regulation and a fairly narrow congressional charter. FHLBanks maintain ongoing communication with their borrowers' regulators. FHLBanks act as partners in providing liquidity in good and bad times on a wide range of collateral under rules understood by all parties, including the member's regulator.

The legislative change being sought does not change the FHLBanks from unsecured to secured creditors; the FHLBanks are already perfected secured IC creditors. The legal protections that the FHLBanks enjoy under the FDIA (i.e., not being subject to voidable preference challenges or stays) are part of the risk mitigation in the FHLBank System that has ensured no losses on an advance to an IDI member.

This legislation will benefit insurance regulators, guaranty associations, rehabilitators, liquidators, and insurance companies by fostering a healthier industry and providing additional resources and tools to address the remote situations involving a failed IC member of an FHLBank.

A. Increase tools for dealing with a weak IC:

- The passage of the legislation will enhance the operating flexibility for rehabilitators. This includes:
 - Allowing FHLBank advances (provided that they are adequately secured) to remain outstanding to such institutions and be repaid in an orderly manner. As the advances are repaid, the FHLBank will release its rights in the pledged collateral allowing the rehabilitator to deal with the assets and maximize their value.
 - Because of the existing statutory protections, with IDI members that are placed into FDIC receivership, FHLBanks can and do regularly leave outstanding advances in place. FHLBanks do not seek a prompt sale of the underlying collateral.
 - This approach is the usual, established and preferred method for FHLBanks to handle receiverships.
- This change will reduce the risk that an FHLBank will be forced to seek a prompt sale of the underlying collateral to protect the FHLBank's interest.

B. Impact on Guaranty Associations

The proposed language will not generally impact assets available to a guaranty association in the event of a failure of an FHLBank IC borrower. Under current FHLBank lending to ICs:

- FHLBank lending is required by statute and regulation to be fully secured by high quality collateral (treasury and agency securities (including agency MBS), mortgage loans, or certain highly rated non-government/agency securities).

- FHLBanks perfect their security interest in collateral pledged by members and monitor its value.
- Collateral delivery for IC collateral is the norm.

The legislation would benefit the state guaranty association by:

- a) Reducing the amount of overcollateralization required for healthy IC members to borrow from the FHLBank, making those assets otherwise available to the IC member (and to the guaranty association in the event of insolvency).
- b) Expanding the funding options for less liquid assets of healthy IC members, resulting in more liquid assets such as Treasury and Agency securities being available to the IC member (and to the guaranty association in the event of insolvency).
- c) In the remote event of an FHLBank member IC's insolvency, the risk that the FHLBank would seek to promptly realize on its collateral to preserve its value is reduced.
- d) The rehabilitator's options for dealing with the insolvency are increased and can include transferring existing FHLBank funding to the IC to the acquirer of operations of the failed IC or leaving the FHLBank funding outstanding.

V. FHLBank Practice with FDIC IDIs

In lending to their FDIC-insured member banks, FHLBanks have specific federal statutory and regulatory protections from:

- (1) risk that collateral securing their advances can be "clawed back" by a receiver, and
- (2) risk that a receiver can delay an FHLBank's access to pledged collateral or its ability to exercise its rights against the collateral pledged.

In part, because of these legal protections, the FHLBanks can lend to their depository institution members throughout economic cycles, and, in the case of their federally regulated members, with approval of their regulator, even when such institutions are close to insolvency or insolvent.⁴ The change that the FHLBanks are seeking would similarly allow the FHLBanks to lend to troubled IC members, with their regulator's approval.

VI. Legislation will Address FHLBank Regulator Concerns that Could Impact FHLBank IC Borrowing

Revising State Insolvency Acts as described will reduce a regulatory risk to IC members. FHLBank lending to insurance companies has been a matter of focus by the FHFA:

- Draft Advisory Bulletin Issued by the FHFA in October 2012 on FHLBank Lending to Insurance Company Members

⁴ The federal super lien priority set forth in the FHLBank Act which gives an FHLBank's security interest priority over a receiver's interest in the assets pledged by the institution, even where the FHLBank's security interest is not perfected, provides additional legal protection to the FHLBanks.

- June 2012 FHFA-IG report noted that FHLBanks' increased lending to insurance companies as a risk issue that bears watching
- Statements by FHFA Acting Director DeMarco at recent FHLBank director conferences

Future FHFA regulatory actions could include:

- Requiring FHLBanks to hold additional capital or reserves against their outstanding advances to insurance company members
- Requiring more onerous collateral management practices
- Imposing higher collateral haircuts
- Limiting the range of collateral

Illustrative Draft Language

Proposed Revision to Section 108 E. Injunctions and Orders of the NAIC Insurer Receivership Model Act

E. Notwithstanding Subsection C, the commencement of a delinquency proceeding under this Act does not operate as a stay or prohibition of:

- (1) Except as provided in Subsection C(7), regulatory actions by the commissioners of non-domiciliary states, including, but not limited to the suspension of licenses;
- (2) Criminal actions;
- (3) Any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent the act is accomplished within any relation back period under applicable law;
- (4) Setoff as permitted by Section 609;
- (5) Pursuit and enforcement of non-monetary governmental claims, judgments and proceedings;
- (6) Presentment of a negotiable instrument and the giving of notice of and protesting dishonor of the instrument;
- (7) Enforcement of rights against single beneficiary trusts established pursuant to and in compliance with [cite to the credit for reinsurance law];
- (8) Any right to cause the netting, liquidation, setoff, termination, acceleration or close out of obligations, or enforcement of any security agreement or arrangement or other credit enhancement or guarantee or reimbursement obligation, under or in connection with any netting agreement or qualified financial contract as provided for in Section 711;
- (9) Discharge by the guaranty association of statutory responsibilities under any applicable guaranty association act; or
- (10) Any of the following actions:
 - (a) An audit by a governmental unit to determine tax liability;
 - (b) The issuance to the insurer by a governmental unit of a notice of tax deficiency;
 - (c) A demand for tax returns;
 - (d) The making of an assessment for any tax and issuance of a notice and demand for payment of the assessment; or
 - (e) The exercise by a Federal Home Loan Bank of its rights regarding collateral pledged under a security agreement (or any pledge, security, collateral or guarantee agreement or any other similar arrangement or credit enhancement relating to such Federal Home Loan Bank security agreement).

Proposed Revision to Section 604 C. Voidable Preferences and Liens of the NAIC Insurer Receivership Model Act

C. The receiver may not avoid a transfer under this section:

- (1) To the extent that the transfer was:
 - (a) Intended by the insurer and the creditor to or for whose benefit the transfer was made to be a contemporaneous exchange for new value given to the insurer; and
 - (b) In fact a substantially contemporaneous exchange;
- (2) To the extent that the transfer was in payment of a debt incurred by the insurer in the ordinary course of business or financial affairs between the insurer and the transferee and the transfer was:
 - (a) Made in the ordinary course of business or financial affairs between the insurer and the transferee; or
 - (b) Made according to ordinary business terms;
- (3) To or for the benefit of a creditor, to the extent that, after the transfer, the creditor gave new value to or for the benefit of the insurer:
 - (a) Not secured by an otherwise unavoidable security interest; and
 - (b) On account of which new value the insurer did not make an otherwise unavoidable transfer to or for the benefit of the creditor;
- (4) To the extent the transfer was made in respect of a bond posted in connection with an administrative or judicial proceeding in order to appeal, set aside, or stay execution of a judgment; or
- (5) Of money or other property arising under or in connection with a Federal Home Loan Bank security agreement (or any pledge, security, collateral or guarantee agreement or any other similar arrangement or credit enhancement relating to such Federal Home Loan Bank security agreement).