

To: Receivership and Insolvency (E) Task Force

From: Federal Home Loan Bank Legislation (E) Subgroup

Date: November 18, 2013

Re: Report on Study of Federal Home Loan Bank's Proposed Receivership Legislation

---

### **SUMMARY**

The Federal Home Loan Bank Legislation (E) Subgroup has completed a study of the Federal Home Loan Banks' (FHLBanks) proposed receivership legislation which proposes amendments to states' receivership laws to provide for exemptions from stay and voidable preference provisions. The Subgroup observed that the FHLBanks' proposed legislation has no perceived benefit to the receivership process. One of the initial goals of the study was to attempt to provide for uniformity across all states in addressing this legislative request; however despite the Subgroup's effort, uniform legislation could not be achieved. The Subgroup therefore recommends that each state make its own determination regarding the proposed exemption based on that state's existing receivership law and any other factors the state feels appropriate. Specifically, the Subgroup makes the following recommendations: 1) send to state insurance commissioners this report containing guidance and recommendations should the legislation be proposed in their state; 2) update the *Receivers Handbook for Insurance Company Insolvencies* to include information for dealing with an insolvency where FHLBank agreements may be involved; and 3) provide to state insurance commissioners research completed by the Subgroup.

### **BACKGROUND**

At the 2012 Fall National Meeting, the Federal Home Loan Banks (FHLBanks) introduced to the Receivership & Insolvency (E) Task Force draft language that proposes amendments to states' receivership laws. The proposed amendments to the *Insurer Receivership Model Act* (Model #555—IRMA) Section 108 Injunctions and Order, and Section 604 Voidable Preferences and Liens, or equivalent state statutes, would allow an exemption from stay and voidable preference provisions for security agreements with the FHLBank. Additionally the Federal Housing Finance Agency (FHFA) issued a Draft Advisory Bulletin in October 2012 highlighting the FHFA's views on the risks of lending to insurance companies posed to FHLBanks.

At the 2012 Fall National Meeting, the Federal Home Loan Bank Legislation (E) Subgroup of the Receivership & Insolvency Task Force was charged with studying the FHLBanks' proposed legislation and providing input and recommendations on receivership considerations.

### **RECOMMENDATIONS TO THE RECEIVERSHIP AND INSOLVENCY (E) TASK FORCE AND FINANCIAL CONDITION (E) COMMITTEE**

The Subgroup, through many productive discussions, attempted to reach an agreement with the FHLBanks on appropriate legislative language. The FHLBanks worked collaboratively amongst the twelve individual banks to provide timely responses to the Subgroup's many questions. The FHLBanks have suggested to the Subgroup that if exemptions to stay and voidable preference provisions are adopted in states, the FHLBanks may lower collateral requirements which may lead to an increase in FHLBank transactions with insurance companies. The

Subgroup does not support or oppose the FHLBanks original draft language; however, it offers the following recommendations.

**1. States should determine the necessity for creating exemptions that apply exclusively to an FHLBank, and the potential impact of the proposed amendments.** The following are issues to consider:

▪ Existing provisions governing secured claims

Receivership statutes recognize the rights of secured claimants, and provide remedies with respect to the security held for the transaction. These provisions will typically specify that the value of security is determined in accordance to the terms of the agreement under which the security is held.

▪ Existing relief from automatic stay

The stay that is imposed by the commencement of a receivership is typically subject to exceptions, and/or remedies that permit the lifting of the stay, or other relief from the stay.

▪ Existing exceptions to voidable transaction powers

Provisions allowing a Receiver to avoid preferences are subject to exceptions, which ensure that certain transactions are not voided. The Insurer Receivership Model Act provides an exception for transfers made in the ordinary course of business. A transaction with an FHLBank would presumably be made in the ordinary course of business, and exempted under a statute based on this model law. The exemption proposed by the FHLBanks would apparently apply even in the unlikely event that a transaction was not made in the ordinary course of business.

▪ Conditions for exceptions

The exemptions proposed by the FHLBanks are unconditional; an insurer's compliance with state insurance laws and an FHLBank's compliance with applicable federal law are not prerequisites for the exemptions. For example, if an insurer failed to comply with a requirement for regulatory approval of an encumbrance of assets in connection with a loan by an FHLBank, the encumbrance could not be voided in the event of receivership.

**2. Alternative Legislative Language.** If states are considering adoption of the FHLBanks' original proposed legislation in their state law, the Subgroup recommends states consider the following additional requirements either in legislative language or via a memorandum of understanding (MOU) with the FHLBank, as deemed appropriate by the state department of insurance. The following language is intended to address the concerns of fraudulent transfers and communication between the FHLBank and the state regulator in the event of a receivership action.

To address communication, states may consider including the following in the states' receivership provision for Secured Creditor (equivalent of IRMA, Section 710-Secured Creditors) or address via an MOU:

(1) The FHLBank shall, upon the request of the [receiver, conservator, rehabilitator or liquidator] within [number of days] of the request, provide a process and establish timing [within no more than \_\_\_ days following the receivership order] for:

(a) The release of collateral that exceeds (the required lending value (as determined in accordance with the advance agreement with the FHLBank)]credit obligations remaining after any repayment of advances;

(b) The release of any excess collateral following repayment of all outstanding credit obligations in full;

- (c) The payment of fees and the operation of deposits and other accounts with the FHLBank; and
  - (d) The possible redemption or repurchase of FHLBank stock or excess stock of any class that an insurer member is required to own.
- (2) The FHLBank subject to this subsection shall, upon the request of the [receiver, conservator, rehabilitator or liquidator] and to the extent that (i) market conditions, (ii) the terms of the advances outstanding to the insurer member, and (iii) the applicable policies of the FHLBank and in compliance with the FHLBank Act and corresponding regulations provide any available options for an insurer member subject to a delinquency proceeding to renew or restructure an advance to defer associated prepayment fees.

Additionally, the Subgroup had several discussions about a cap on the stay period that would provide for a shortened time period for receivers to assess the company in receivership before the stay was lifted. The Subgroup suggests that states could consider discussing with their respective FHLBanks the impact of a limited stay of no more than 30-days after which time the stay would be lifted for FHLBanks, based on an understanding of what actions would be restricted by the stay in that state. A 30-day stay should be considered in conjunction with language allowing for exemptions in the ordinary course of business.

To address fraudulent transfers, states may consider adding the underlined sentences below to the FHLB's proposed revision to the states' receivership provision equivalent to IRMA Section 604 - Voidable Preferences and Liens. The addition of the last sentence (but not the underlined language preceding it) was included in the Nebraska receivership law, which allows for an exemption from fraudulent transfers. NEB. REV. STAT. § 44-4826 (2013)

[FHLB proposed language] A receiver may not avoid any transfer of, or any obligation to transfer, money or any other property arising under or in connection with any 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 made in the ordinary course of business and in compliance with the applicable FHLBank agreement. However, a transfer may be avoided under this subsection if it was made with actual intent to hinder, delay, or defraud either existing or future creditors.

Similar language is included in IRMA Section 604 (C) 2 regarding voidable preference for transactions in the normal course of business. States should ensure that they have adopted language to address extraordinary or fraudulent transfers.

- 3. Regulatory Communication and Oversight.** The Subgroup recognizes the work streams being conducted by the Restricted Assets (E) Subgroup and believes the combined financial solvency and receivership review is appropriate. The Restricted Assets (E) Subgroup was formed to address issues related to assets that are pledged or restricted. The Subgroup believes the adopted annual/quarterly financial statement disclosures will assist regulators in assessing risks associated with potentially high amounts of restricted assets and anticipates the outcome of further liquidity discussions at the Restricted Assets (E) Subgroup.

Regarding pre-receivership considerations, the Subgroup recommends the following.

- a. State insurance regulators should consider engaging in discussions and/or a memorandum of understanding with their respective FHLBank to understand, agree and document minimum expectations for handling of FHLBank agreements in an insurance rehabilitation or liquidation situation. These discussions and/or MOUs should consider addressing the following areas:
  - i. Redemption and repurchase of capital stock
  - ii. Release of collateral in excess of required collateral

- iii. Pre-payment fees
  - iv. Collateral substitutions
  - v. Transactions with financially troubled insurers
  - vi. Renegotiation of terms of an agreement
  - vii. Transfer of an agreement to a purchaser
  - viii. Differences in the handling of an agreement in a rehabilitation vs. a liquidation
- b. State insurance regulators should exercise their regulatory authority, where appropriate, to regulate their domestic insurers' use of FHLB agreements. Specifically, because the FHFA regulations require the FHLBank to follow the direction of the member's regulator with respect to making advances to capital deficient members or those without positive tangible capital, if insurers are deemed financially troubled, the regulator should determine if FHLB agreements are appropriate for the insurer's financial situation, and if not, work with the insurer and the FHLBank to limit or reduce any material risks prior to entering a receivership situation.
- 4. Best Practices/Guidance for the *Receivers' Handbook for Insurance Company Insolvencies*.** The Subgroup recognized that the experiences of the insurance departments, receivers and FHLBanks involved in the rehabilitations of the Shenandoah Life Insurance Company and Standard Life Insurance Company of Indiana could provide useful best practices and guidance in the event of future insurance company insolvencies with respect to the handling of outstanding FHLBank advances. The Subgroup is currently drafting new best practices and guidance for the Handbook.
- 5. Notice to State Insurance Commissioners on the Completion of this Study and Recommendations.** As states are preparing for 2014 legislative sessions, the Subgroup recommends a notice be provided to state insurance commissioners including this memo which outlines the research completed by the Subgroup as well as the above recommendations.

## SUMMARY OF STUDY RESULTS<sup>1</sup>

### INFORMATION GATHERING

The Subgroup held meetings or conference calls to research the topic in 2012 on Dec. 10 and in 2013 on Feb 8, April 6, April 29, May 20, June 10, July 1, July 22, Aug.16, Oct. 30 and Nov. 18. The Subgroup: 1) surveyed regulators to identify possible areas of interest or regulatory concerns with the proposed legislation; 2) heard a presentation from representatives of the FHLBanks at the 2013 NAIC Spring National Meeting; 3) conducted multiple open conference calls between regulators, the FHLBanks and other interested parties; 4) received supporting materials from the FHLBanks regarding certain topics discussed; 5) considered alternative language for IRMA Section 710-Secured Creditors; and 6) drafted recommendations for state insurance regulators.

### KEY OBSERVATIONS AND CONSIDERATIONS

The Subgroup completed its study and provides the following observations and considerations including explanations from the FHLBanks of the following key topics that were discussed.

1. **Concerns of State Insurance Regulators & Receivers.** The Subgroup observed that the FHLBanks' proposed legislation has no perceived benefit to the receivership process and would provide a preferred secured creditor class to the FHLBanks which, from a receivership perspective, may impact other secured creditors, policyholders and guaranty funds. Under the FHLBank proposal, the increased protection afforded to the FHLBank may result in the FHLBank receiving a disproportionate share of assets and the assets available to other secured creditors, policyholders, and guaranty funds may be reduced.

State insurance regulators and receivers discussed several other concerns with the proposed legislation, including:

- a. Allowing an exemption from stay and voidable preference provisions may have a detrimental impact on: 1) the management of the receivership because the receiver may not have sufficient time following the delinquency proceeding to evaluate the assets of the estate and identify any fraud before the FHLBank exercises its rights to collateral; and 2) the ability of the receiver to maximize the value and liquidity of the estate for the benefit of policyholders because FHLBank capital stock held by the insurer is illiquid.
  - b. The need to post excess collateral, as much as 125% of outstanding balances, required under the FHLBank agreement, can create added strain on a troubled insurer.
  - c. IRMA and state statutes already afford protections to secured creditors. There is no evidence that the current statutory protections as a secured creditor are inadequate.
  - d. The adoption of such exemptions may trigger other secured creditors to demand similar treatment.
  - e. While the FHLBanks have indicated that it could loosen the collateralization requirements if the exemptions are adopted, FHLBanks cannot be required to loosen collateral due to changes in state law.
  - f. While the FHFA requested FHLBanks receive similar treatment under state law as is provided under Federal law, it should be noted that insurance company liquidations differ from bank liquidations in many ways.
2. **FHLBanks' view of its request for exemptions.** FHLBanks state that it seeks parity with Federal law (Federal Home Loan Bank Act) which provides similar treatment for the Federal Reserve Banks. The FHLBanks state that the exemptions would give FHLBanks more certainty and clarity on its ability to assess & manage collateral during a receivership, thereby allowing the FHLBank to reduce the incremental risk of a stay or preference period that is included in required collateral calculations. (*FHLBank 05-16-13 Memo*)
    - **How the FHLBanks view insurers and state insurance regulators will benefit from the exemption.** The FHLBanks outlined the FHLBank system and its long history of being able to serve

---

<sup>1</sup> FHLBank memos referenced in the Key Observations and Considerations section of this report are available in the *NAIC 2013 Summer National Meeting Proceedings*.

as an affordable source of capital and liquidity for insurance company members. The FHLBanks state that the exemption would allow an FHLBank to reduce the incremental risk associated with the uncertainty of the stay and preference provision thereby allowing collateral requirements on healthy insurers to be reduced and to allow the insurer to post less liquid securities as collateral. Insurers entering receivership would have a reduced collateral requirement. The FHLBank of Topeka provided examples in Oklahoma and Nebraska that currently have the exemptions where the FHLBank of Topeka was able to adopt more favorable collateral terms allowing for reduced collateral requirements for insurers in those states. (Note that the Subgroup did not verify the accuracy of the information provided.) The FHLBanks believe insurers will benefit from being able to borrow on more favorable terms than currently available. The FHLBanks believes the receivers will benefit from the removal of uncertainty and the ability of the FHLBank to provide greater flexibility in working with the receiver as well as reduce legal expenses incurred by the estate related to resolving the handling of the agreements. (*FHLBank 05-16-13 Memo*)

3. **FHLBank status under Federal law.** FHLBanks are regulated by the FHFA. FHLBanks are formed as Government Chartered Cooperatives under the Federal Home Loan Bank Act. Each of the twelve banks is independently managed and governed by a separate board of directors. Due to this independence, each bank may have different capital plans, required collateral methodologies, capital stock repurchase programs, and etc. Specific Federal laws and regulations governing FHLBank activities that were discussed include:
  - a. **Redemption and repurchase of mandatory capital stock purchases** is restricted under Federal law 12 U.S.C. § 1426(a) Capital structure of Federal Home Loan Banks and Federal Statute 12 C.F.R. § 931.7 Redemption and repurchase of capital stock. No FHLBank shareholders (or receivers of an insurance company member) have the right to have excess stock redeemed or repurchased prior to the expiration of the redemption period and applied to the outstanding debt. (*FHLBank 07-1-13 Response*)
  - b. **Waiving of pre-payment fees** are prohibited under Federal law 12 C.F.R. § 1266.6. Pre-payment fees are negotiated as part of the advance transaction. Advances without prepayment fees can be made but result in less favorable terms or costs (i.e. potentially higher interest rates or other associated fees to protect the FHLBank against additional risk). (*FHLBank 05-16-13 Memo*)
  - c. **Required Collateral.**—Federal law (12 U.S.C. § 1430 – Advances to Members) requires the FHLBank to hold collateral sufficient to fully secure the advances obtained from the FHLBank. The Federal law also defines the categories of collateral. Collateral cannot be released until outstanding obligations are repaid as FHLBanks are required to ensure that outstanding advances to all its members (including those in receivership) are fully secured at all times, and the amount of collateral the FHLBanks hold is determined in good faith to be the amount necessary to ensure that the obligations remain fully secured even if the collateral declines in value. (*FHLBank 07-1-13 Response*) FHLBanks manage repayment risk through collateral haircuts, so the excess collateral above the amount owed on the advance is required collateral needed to cover incremental risk. The amount of required collateral is calculated based on modeling, the quality and liquidity of the collateral and the credit strength of the borrower. Additional collateral is required to cover incremental risk factors including the length of time the FHLBank would have to manage volatility during a stay or preference period. (*FHLBank 05-16-13 Memo*)
  - d. **New or increased advance transactions with capital deficient insurers** by the FHLBank are governed under Federal law (12 C.F.R. § 1266.4). FHFA regulations require the FHLBank to follow the direction of the member’s regulator with respect to making advances to capital deficient members or those without positive tangible capital. (*FHLBank 05-16-13 Memo*)
4. **Previous Experiences in Receivership.** The receivers and FHLBanks involved in the rehabilitations of the Shenandoah Life Insurance Company and Standard Life Insurance Company of Indiana have identified that the development of best practices may be useful to other state insurance regulators & receivers. The FHLBanks did not suffer any losses on advances made to these two insurers. It was noted that the FHLBank and the rehabilitators worked closely together and communicated often during receivership to achieve a positive result. Some characteristics of this collaboration included the following: a) collateral assets were allowed to be substituted to facilitate portfolio restructuring; b) advances were extended which avoided the

need to liquidate assets immediately, however this took time and added legal expenses to the receivership; and c) advances were allowed to remain outstanding during receivership.

5. **Collateral substitutions.** Collateral substitutions are allowed by the FHLBank; however, it is noted that different asset types may have different collateralization levels.
6. **Consideration of a cap on the Stay Period.** The Subgroup discussed a proposed cap on the stay to a certain number of days after which time the stay would be lifted. The FHLBanks responded that a capped stay period would not remove the incremental risk caused by the stay period as market fluctuations resulting in declining value of collateral assets may still occur during the stay period. (*FHLBank 6-19-13 Memo*).
7. **Other Secured Creditors' possible demand for similar exemption.** As stated above, a concern of regulators was that other secured creditors may demand similar exemptions under state law. The FHLBanks stated FHLBanks are only seeking legislation to provide parity with Federal law. Federal law only provides similar treatment for Federal Reserve Banks. Other secured creditors, unlike the FHLBanks, regularly incur and manage bankruptcy stay, voidable preference, and comparable risks which are similar to the insurance insolvency statutory risks. Unlike other creditors, Federal law requires the FHLBanks to be fully secured at all times so that the FHLBanks remain reliable sources of liquidity to its members during financially stressed conditions. (*FHLBank 05-16-13 Memo*)
8. **Sharing of confidential information between FHLBanks and state insurance departments.** The FHLBank considers the sharing of confidential information as a potential mitigant to concerns by state insurance departments regarding increasing advances to financially troubled insurers. However, the ability of the state insurance department to share confidential information with the FHLBank is governed by the laws of the state and most states' laws would not permit the sharing of confidential information with a creditor. Current NAIC Models do not permit sharing of confidential information with the FHLBank. Each state should assess its own laws to determine what level of sharing is permitted.
9. **Memorandums of Understanding (MOU) between an individual state insurance department and its respective FHLBank.** The FHLBanks suggested individual MOUs between the state insurance department and the FHLBank as a means to document and clarify expectations going into receivership such as information sharing, prepayment fees, collateral maintenance, transferring advances and capital stock. (*FHLBank 05-16-13 Memo*) The Subgroup noted this may be beneficial for state insurance departments whose domestic insurers are FHLBank members; however also noted that MOUs are most likely to lack uniformity across states as each state and respective FHLBank would need to develop an MOU that is mutually agreeable.
10. **Other Available Information.** Although the Subgroup did not specifically discuss the details of the following reports during its study, state insurance departments may wish to consider them as additional sources of information to help understand the FHLBank system.
  - NAIC Capital Markets Special Report titled, "The U.S. Insurance Industry's Exposure to the Federal Home Loan Bank System" issued Dec. 14, 2012, which notes that as of Dec. 31, 2011, there were 234 insurance company FHLBank members, 100 of which had advances. [http://www.naic.org/capital\\_markets\\_archive/121214.htm](http://www.naic.org/capital_markets_archive/121214.htm)
  - Fitch Ratings Special Report, "The Federal Home Loan Bank System. It's Role in the Life Insurance Industry" 06-12-13.
  - U.S. Government Accountability Office June 2013 Report "INSURANCE MARKETS, Impacts of and Regulatory Response to the 2007-2009 Financial Crisis" [GAO-13-583]

If you have any questions about this report, please contact Paul Miller, Chair of the Federal Home Loan Bank Legislation (E) Subgroup ([pmiller@osdchi.com](mailto:pmiller@osdchi.com)) or NAIC Staff, Jane Koenigsman, ([jkoenigsman@naic.org](mailto:jkoenigsman@naic.org)).