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Understanding the relationship between life insurers and the Federal Home Loan Banks

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This article describes the growing relationship between life insurance companies and the Federal Home Loan Banking (FHLB) system. Given the important role that both play in the U.S. financial system, it is important to understand how they are connected.

As of 2012, approximately 15% of the insurance industry's assets supported housing finance.

The FHLB system

The Federal Home Loan Banks were established in 1932 to support the housing market by providing low-cost funding to financial institutions that make loans to homeowners. The FHLB system comprises 12 regional banks and the Office of Finance. The banks are organized as cooperatives of mortgage lenders within a geographical region that can apply for loans called "advances" from their regional FHLB. FHLB advances are secured by collateral, which can range from mortgages to U.S. Treasury bonds.

To be eligible for FHLB membership, a company must be engaged in housing finance, defined as purchasing or originating long-term home mortgage loans or holding mortgage-backed securities. Insurance companies play an important role in housing finance and as of 2012, approximately 15% of the insurance industry's assets supported housing finance.[1] Insurance companies (and banks) must apply for membership to the relevant regional FHLB, based on their principal place of business. Belonging to an FHLB is attractive to insurance companies because FHLB advances are a low-cost, flexible source of funding. Insurance companies may use advances to diversify their sources of funding, access liquidity in times of financial disruptions, or enhance investment yields through more robust liquidity management.[2]

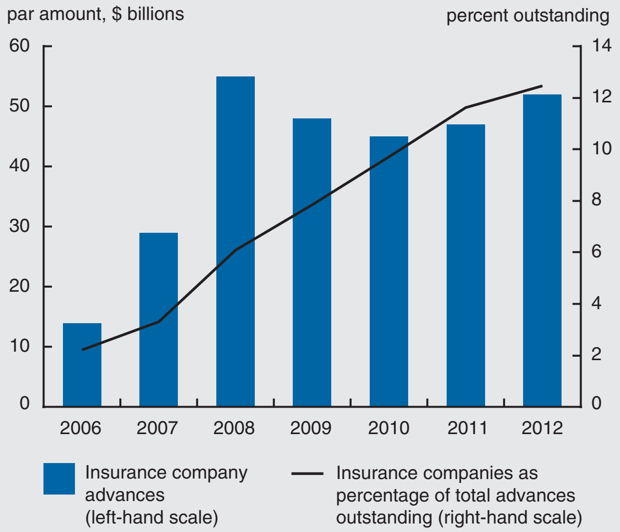
A growing relationship

The percentage of all FHLB advances that were provided to insurance companies quadrupled between 2007 and 2012, growing from 3% in 2007 to 12% and a total of $52 billion in 2012 (see figure 1). While these figures include advances to both life and property casualty companies, life insurers accounted for more than 85% of FHLB advances made to insurance companies in 2012.[3] The total dollar value of advances to insurers peaked during the financial crisis in 2008 when other sources of liquidity became more difficult to find; it has remained relatively constant since then.[4]

For the FHLBs, the relative importance of insurance companies as clients varies widely across banks. While two-thirds of FHLBs had less than 10% of total outstanding advances to insurance companies at the end of 2012, the Des Moines and Indianapolis banks both had over 45% (see figure 2). This variation is influenced by the geographical distribution of insurance companies, the individual FHLB's appetite for extending advances to insurance companies, and differences in state law.

The use of FHLB advances by life insurance companies is fairly concentrated.

1. FHLB advances to insurance companies



NOTE: Includes both life and property and casualty insurance companies.

SOURCE: FHLB annual reports, available at www.fhlb-of.com/ofweb_userWeb/pageBuilder/fhlbank-financial-data-36.

2. FHLB advances to insurance companies, by FHLB region

	Insurance advances ($ billions)	Total advances ($ billions)	Percentage of total advances
Atlanta	N/A	87.5	N/A
Boston	1.5	20.8	7
Chicago	1.0	14.5	7
Cincinnati	3.0	53.9	6
Dallas	0.4	18.4	2
Des Moines	15.2	26.6	57
Indianapolis	8.4	18.1	47
New York	17.2	75.9	23
Pittsburgh	N/A	40.5	N/A
San Francisco	0.0	43.8	0
Seattle	0.0	9.1	0
Topeka	3.4	16.6	20
Total	51.6	425.8	12

NOTES: Includes both life and property and casualty insurance companies. Insurance advances were not available for the Atlanta and Pittsburgh FHLB regions separately, but combined they equaled $1.5 billion.

SOURCE: 2012 Regional FHLB 10K filings.

The top 15 life insurance borrowers accounted for 90% of FHLB advances to the industry in 2012. However, even for these companies, FHLB advances are a small share of total general-account liabilities.[5] Among the three large life insurers—AIG, Prudential, and MetLife—that were recently classified as global systemically important insurers (G-SIIs) by the Financial Stability Board, MetLife's use of FHLB advances across its life insurance subsidiaries is the largest at $15.6 billion.[6] However, this accounts for just 5% of MetLife's total general-account liabilities. AIG's subsidiaries had $82 million in outstanding advances (or 0.05% of general-account liabilities) at the end of 2012, and Prudential had outstanding advances of $2.3 billion across its life insurance subsidiaries (or 1.2% of general-account liabilities).[7] Of the top 15 FHLB life insurance borrowers, only three had FHLB advances that accounted for more than 5% of their general-account liabilities—Guggenheim Capital, CNO, and OneAmerica. Guggenheim Capital's life insurance subsidiaries had the largest share, with advances equal to 14% of total general-account liabilities at the end of 2012.[8]

The top 15 life insurance borrowers accounted for 90% of FHLB advances to the industry in 2012.

Uncertainty during insolvency proceedings

Insurance companies represent an important area of growth for FHLBs, but the FHLBs and their regulator, the Federal Housing Finance Authority (FHFA) have raised some concerns about this growing relationship related to the resolution process for insolvent insurance companies. When an insurance company becomes financially distressed and cannot meet its obligations, a state insurance commissioner takes control of the company's operations and places it into receivership.[9] If the company cannot be rehabilitated, it is declared insolvent and the commissioner liquidates the company. The commissioner's primary responsibility is to convert the insurance company's assets to cash and to distribute this cash to policyholders and creditors, according to the priority of their claims.

There is some uncertainty surrounding the FHLBs' claim to collateral on outstanding advances made to insurance companies in the case of an insurance company failure. In addition to potential legal uncertainty, insurance company failures happen very infrequently, so the life insurance resolution process is an unfamiliar and largely untested process for many FHLBs. While FHLBs have a long relationship working with the Federal Deposit Insurance Corporation, which handles the division of assets for bank insolvencies, they may not have the same familiarity with state insurance commissioners. One concern for FHLBs is that these factors could lead to a lengthy settlement process that might prevent the timely liquidation of the collateral backing FHLB advances.

The case of Standard Life Insurance Company of Indiana provides a useful example of successful cooperation among an FHLB, state insurance regulators, and an insurance company. Standard Life was placed into receivership in 2008. The FHLB of Indianapolis worked closely with Standard Life and their rehabilitator to ensure that Standard Life's advances remained fully collateralized, while also allowing the struggling company flexibility in the type of collateral posted. Ultimately, the rehabilitation process was successful, Standard Life was able to avoid insolvency, and the FHLB of Indianapolis did not experience any losses on its advances to Standard.[10] This experience led to the passage of laws in Indiana and Michigan (the two states in the district of the FHLB of Indianapolis) clarifying the FHLB's status as a secured creditor.[11]

While Michigan and Indiana have taken steps to add clarity to the FHLBs' rights in insolvency proceedings, there is still considerable uncertainty for other FHLBs. As a result of this uncertainty, FHLBs may require insurance companies to provide more collateral for advances than they require from banks. This practice varies by FHLB region. FHLBs are also more likely to take actual possession of collateral posted by insurers, and some FHLBs may place limits on lending to the insurance industry.[12] In contrast, when FHLBs lend to financially strong banks, they typically do not take actual possession of the collateral.

For their part, insurers have raised the concern that an FHLB might require an insurer to post additional collateral for an advance if the insurance company's financial performance deteriorates.[13] This could potentially limit the flexibility of FHLB advances and make them more expensive at the very time they could be most useful.[14]

Both insurers and the FHLB system could potentially benefit from uniform and clear rules about FHLBs' rights in insolvency proceedings. The FHFA, which regulates the FHLBs, would like to clarify their status as a secured creditor with a protected first priority security interest in the collateral on their advances to insurers.[15] This would give FHLBs protection from legal delays that could prevent them from accessing collateral in a timely fashion in order to recoup their losses. Legal clarity might also benefit insurance companies if it leads to more favorable collateral practices in FHLB lending, similar to the treatment banks currently receive.

Conclusion

The relationship between insurance companies and Federal Home Loan Banks is important and growing. While FHLB advances are small relative to total general-account liabilities for most insurance companies, FHLB membership can provide them with an important source of liquidity in times of need. The share of FHLB advances going to insurance companies quadrupled from 2007 to 2012, and many FHLBs have expressed a desire to expand their insurance company membership. These trends have led to an increased focus on reducing any uncertainty regarding the treatment of FHLB advances and the collateral that backs them in the resolution process for insolvent insurance companies. Given the significant role that both life insurers and the FHLBs play in the U.S. financial system, and in housing finance in particular, it is important to understand their relationship with one another.

Of the top 15 FHLB life insurance borrowers, only three had FHLB advances that accounted for more than 5% of their general-account liabilities.

1 This number is an approximation calculated from the insurance industry's aggregate holdings of agency mortgage-backed securities (MBS), nonagency MBS, mortgage loans, and real estate. These categories may contain a small number of nonresidential loans. Data are from insurance company statutory filings from SNL Financial.

2 See www.fhlbc.com/Members/Pages/federal-home-loan-bank-chicago-members-insurance-companies.aspx.

3 The percentage of FHLB insurance advances made to life insurance companies was calculated using total life insurance FHLB liabilities as of 2012 from SNL Financial and total advances made to the insurance industry as reported in the 2012 FHLB annual statement; see www.fhlb-of.com/ofweb_userWeb/resources/12yrend.pdf.

4 www.naic.org/documents/committees_e_rfhlbl_sg_related_docs_fhlb_memo_130619.pdf.

5 Life insurers segregate their assets (and, by extension, their liabilities) into two independent "accounts" on their balance sheets—the general account and the separate account. General-account assets support liabilities that feature guaranteed returns to customers from the insurer. In contrast, separate-account assets support "pass-through" products, in which investment gains and losses are passed on to the customer and no more than a minimum return may be guaranteed. Only $2.17 billion of industry FHLB liabilities (or 5% of total FHLB life insurance liabilities) are in separate accounts.

6 See www.financialstabilityboard.org/publications/r_130718.pdf.

7 AIG's and Prudential's outstanding FHLB advances were obtained from their 2012 SEC filings because FHLB liabilities are not always reported consistently by all insurance companies on their statutory filings.

8 Unless otherwise noted, all numbers in this paragraph are based on authors' calculations using statutory filings data from SNL Financial.

9 Federal bankruptcy law specifically excludes insurance companies from bankruptcy proceedings.

10 See www.iair.org/assets/InsuranceReceiver/the%20insurance%20receiver-%20summer%202013.pdf.

11 See www.naic.org/documents/committees_e_rfhlbl_sg_related_docs_fhlb_memo_130619.pdf.

12 See www.fhlbi.com/about/documents/FedHomeLoanBankFundingFigures2013.pdf.

13 See www.fhlb-of.com/ofweb_userWeb/resources/lendingqanda.pdf.

14 See www.naic.org/documents/committees_e_rfhlbl_sg_related_summary_state_survey.pdf.

15 See www.naic.org/documents/committees_e_rfhlbl_sg_related_fhlb_exec_summary.pdf.

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