Q&A

FHLB: Membership, Collateral and Innovative Uses of a Financing Resource for Insurers

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By Matt Reilly, Managing Director, Institutional Solutions

Insurance company interest continues to grow in the Federal Home Loan Bank (FHLB) and its financing programs, as evidenced by the rising insurance company memberships during this first half of 2020.

In addition to increasing their memberships, insurers have been seeking greater details from Conning on a variety of practical issues regarding membership and implementation. We've gathered our answers to the more common questions below.

One prominent suggestion we offer: don't wait until you are in a financial crisis to join your respective FHLB bank (the FHLB system comprises 11 regional banks). We advise joining sooner rather than later – and certainly before you are in an emergency. The membership process can take time and learning about FHLB programs in advance can help an insurer understand all the resources available to develop better strategies to resolve problems.

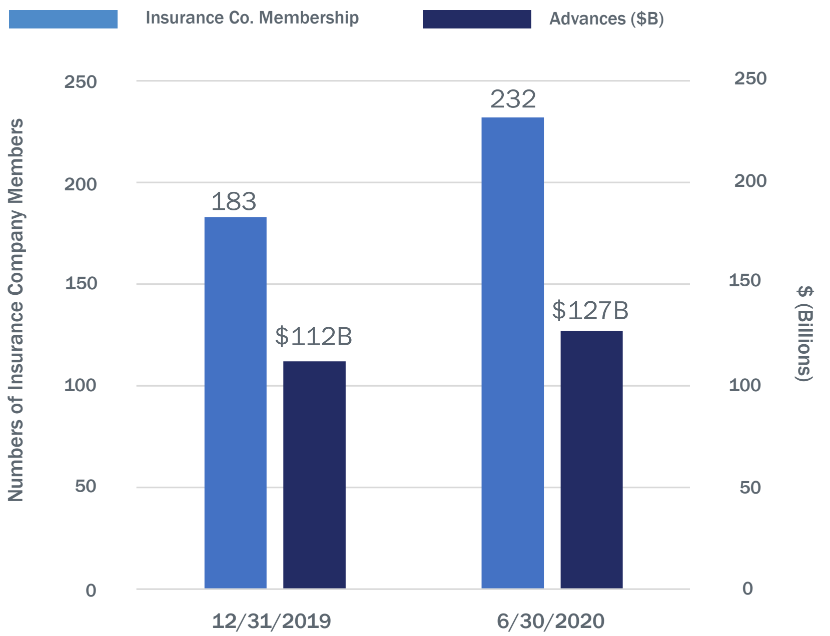
In the Q&A that follows, we discuss FHLB membership growth, the membership process, ideas on best practices for collateral, and views on innovative uses for FHLB financing including pension funding and asset-liability management. (Related items: a recent FHLB opportunity and more about the FHLB.)

1. ***How did the FHLB system respond to insurance company needs during the COVID-19 pandemic?***

In the first six months of 2020, the FHLB system demonstrated resiliency, liquidity and even ingenuity in serving its insurance company clients. Many insurers experienced meaningful portfolio volatility during the first quarter, accentuated in some cases by falling premiums and increased claim uncertainty.

During the first half of 2020, FHLB insurance company membership continued to grow: 232 companies secured advances, up from 183 as of year-end 2019, with total advances increasing 13% to $127 billion (see Figure 1). Additionally, there were examples of FHLB banks taking extra steps to help members, including 0% interest loans, discounted loan rates, and more favorable terms on required FHLB stock among the methods.

Figure 1 Growth in FHLB Insurance Membership, Advances



Prepared by Conning, Inc. Source: "Federal Home Loan Banks Combined Financial Report for the Quarterly Period Ended June 30, 2020," Aug. 13, 2020. http://www.fhlb-of.com/ofweb_userWeb/resources/2020Q2CFR.pdf

2. You suggest insurers join a FHLB before they need funding help. Why?

Conning supports securing an FHLB membership before there is a need because the application and internal governance process takes time. Membership requires purchasing membership stock, with the dollar requirement and dividends varying by regional FHLB. While this ties up an insurer's assets, we suggest viewing this membership stock as an option to access funding at a later date while still providing some level of return, as the stocks do pay a dividend.[1]

"We advise joining your regional FHLB bank sooner rather than later – and certainly before you are in an emergency"

Even an insurer that plans to use the bank infrequently would be wise to join before the need arises. We think it makes sense to ensure the finance/treasury staff, custodians, investment managers, etc., are familiar with the process of drawing down funds and pledging collateral as to help make sure they understand how the "plumbing" works. We think it should be part of your risk management discipline - and it can also serve as a security blanket.

3. When posting collateral for programs, should insurers use more- or less-liquid securities?

Conning believes there is a compelling case to be made for utilizing less-liquid securities for collateralizing FHLB borrowing. While Treasurys, agency pass-throughs and similar government-related securities might have the highest loan-to-value (LTV) ratios and lowest haircuts, they might be less than ideal collateral for some insurers.

First, these high-quality securities are occupying less of insurers' balance sheets; some insurance companies might own 5% or less and they generally have lower expected yields and returns. Holding them just to fill collateral requirements might be a drag on portfolio income and values and offset any gains generated later by an FHLB program. Second, these bonds are part of an insurer's liquid portfolio and pledging them as collateral defeats the purpose of liquid securities.

Using less-liquid loans and securities for collateral has some appeal. Many regional FHLB banks allow for directly underwritten residential or commercial mortgages or other types of real estate exposure as collateral. Insurers do not rely on these assets as a source of liquidity given their higher return potential. Additionally, some regional FHLBs accept non-agency CMBS, CMOs and certain municipal securities (among other securities), which may also have a high yield advantage over the afore-mentioned higher quality securities and which insurers would likely not rely on for liquidity.

These real estate types of collateral often have lower LTV ratios and might require more operational work by an insurer to pledge them as collateral. However, the ability to generate liquidity against an illiquid investment or loan is an intriguing opportunity.

4. What innovative approaches are you seeing among insurers with FHLB advances?

Insurance companies can use FHLB advances for whatever purpose they see fit. Spread investing and funding agreements to increase profitability are quite common for life insurers and seem to be growing for P&C and health insurers. Advances are commonly used as emergency liquidity sources and for a variety of general corporate purposes, including M&A. Advances could also be used to satisfy obligations such as retiring debt and surplus notes issued at higher interest rates.

Another approach is to use an advance to close funding gaps in a defined benefit pension plan. Companies may be able to reap meaningful rewards from the favorable rates of borrowing costs, higher returns in pension plan assets relative to general account assets, and immediate reduction in pension expenses and PGBC premiums. These benefits can immediately flow through to the income statement and release surplus tied up in an underfunded plan.

Another interesting use is leveraging an FHLB advance as a tool in asset/liability management (ALM) for a life insurance company. Many life company liabilities extend decades and have durations that can be in the mid- to high double-digits and even higher, and it can be difficult to match these durations with attractively priced securities. So how to address these needs?

Figure 2 illustrates one approach. By borrowing $100 million (debt) from an FHLB bank at a floating rate (short duration) and then reinvesting those funds in its current strategy (duration of 10), the ALM gap closes from 6 to 1, a meaningful shift.

Figure 2 Using an FHLB Advance as an ALM Tool

	Sample Portfolio				Sample Portfolio with $100 Mil Advance		
	$ (Mil)	Duration	$ Duration (Mil)		$ (Mil)	Duration	$ Duration (Mil)
Assets	1,000	10.0	10,000	**Assets**	1,100	10.0	11,000
Liabilities	800	14.0	11,200	**Liabilties**	800	14.0	11,200
				Debt	100	0.3	25
Surplus	200	-6.0	-1,200	**Surplus**	200	-1.1	-225

Prepared by Conning, Inc.. This sample was prepared using hypothetical data and is for informational purposes only

Conclusion

Conning offers these observations to help financial leaders and management teams consider tools available from the FHLB to address challenging financial circumstances. We welcome the opportunity to talk with you about how FHLB programs may help meet a variety of needs.

Matthew Reilly, CFA, is a Managing Director in Conning's Institutional Solutions group, and leads the team responsible for the creation of investment strategies and solutions for insurance companies. He joined Conning in 2015 and was a portfolio manager before assuming his current role in 2018. Prior to joining Conning, he was with New England Asset Management. Mr. Reilly earned a degree in economics from Colby College.

ABOUT CONNING

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including pension plans, with investment solutions and asset management offerings, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

[1] Past performance is not a guarantee of future results.

Risks:

Market Risk - Market, or systematic, risk is the risk that individual securities may be correlated with general market downturns regardless of the particular business conditions and outlook for the individual companies

Credit Risk – eroding fiscal health in issuing companies resulting in inability to meet debt obligations

Inflation Risk - Inflation erodes the purchasing power of future cash flows from investments. In times of high inflation the value of securities may be reduced

Liquidity Risk - Liquidity risk can occur when market conditions do not allow transactions to be made in a quick and orderly fashion in relation to indicative market prices.

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