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Viewpoint
June 2021
ASSET MANAGEMENT | WHITE PAPER

FHLB for Insurers:
A Source of Incremental Income in a Time of Lower Yields

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A membership in a Federal Home Loan Bank (FHLB) could be a valuable benefit for insurers as its borrowing programs may help enhance profitability, balance-sheet strength and financial stability. FHLB membership is growing among larger insurers and Conning believes it merits further consideration from mid-size companies as well.

Founded in 1932 in response to the Great Depression to support homeownership and distressed lenders, the FHLB has become increasingly popular as a financing option among insurers. Insurance companies can use the FHLB system and its competitive borrowing rates for emergency short-term liquidity backstops, funding for working capital or strategic investments (including mergers and acquisitions), aid in asset-liability management, or potentially generating additional net investment income through spread-investing programs.

While the FHLB's lower-cost financing may be appealing, insurers should still exercise discipline in evaluating the program. Conning's experience in analyzing and measuring a successful borrowing program could offer valuable insight, especially in terms of enhancing an insurer's financial strength through spread-investing programs and improving financial flexibility through liquidity programs.

Membership Growth Amid a Consolidating Industry

The FHLB system comprises 11 regional banks, all of which are independent cooperatives. Each bank has its own operating procedures and membership criteria and services vary. The banks are privately capitalized and owned by thousands of federally insured depository institutions, insurance companies and community development financial institutions from across the U.S. They are regulated by the Federal Housing Finance Agency and registered with the Securities and Exchange Commission.

Figure 1 Growth in FHLB Insurance Company Membership, Advances 2016-2020

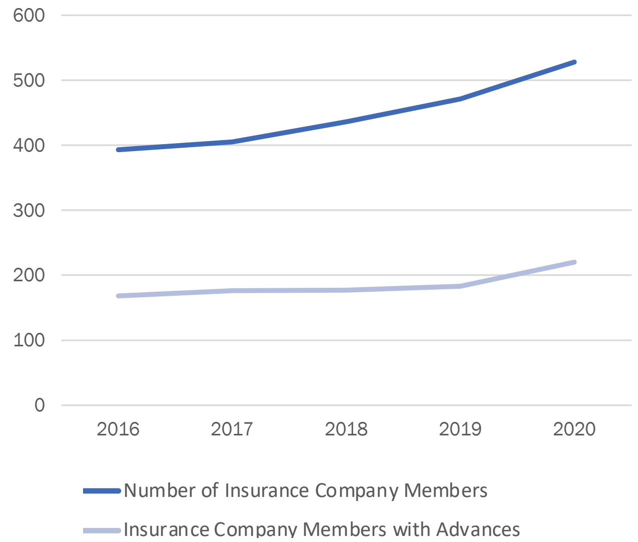

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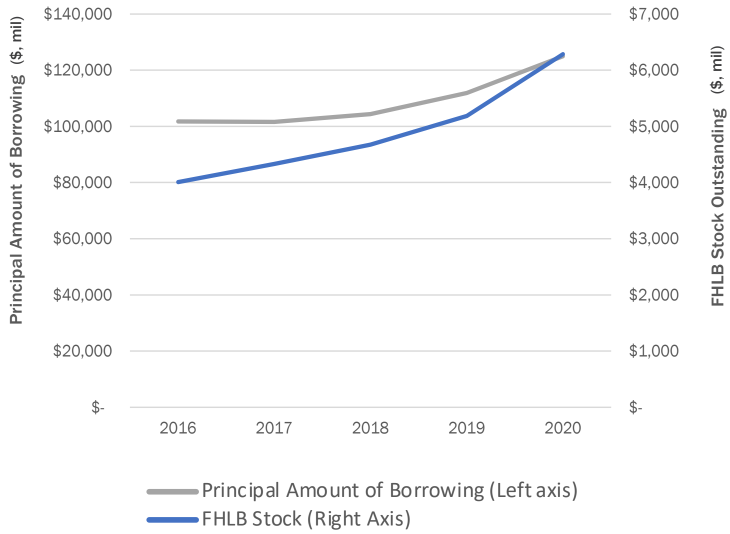
Figure 2 Insurance Company FHLB Stock and Borrowing 2016-2020



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A growing number of insurance companies are looking to take advantage of FHLB programs, witnessed by the continuing increase in their membership rate and borrowing activities (see Figures 1 & 2). At year-end 2020, 528 insurance companies were FHLB members, up from 393 at year-end 2016, an annual growth rate of 6%. During that same period, the total principal of outstanding advances rose to $125 billion from nearly $102 billion, a 4% annual growth rate.[1]

Steps to Securing FHLB Financing

There are a few steps required for insurers to participate in FHLB programs.

Borrowers must first become a member of an FHLB and may join their regional bank, provided they meet its criteria. While a simple process, becoming a member can consume scarce governance resources (board approval, management discussions, etc.). The first steps typically require some financial disclosures and the subsequent commitment and purchase of FHLB membership stock, an amount usually commensurate with the size of an insurer's balance sheet.

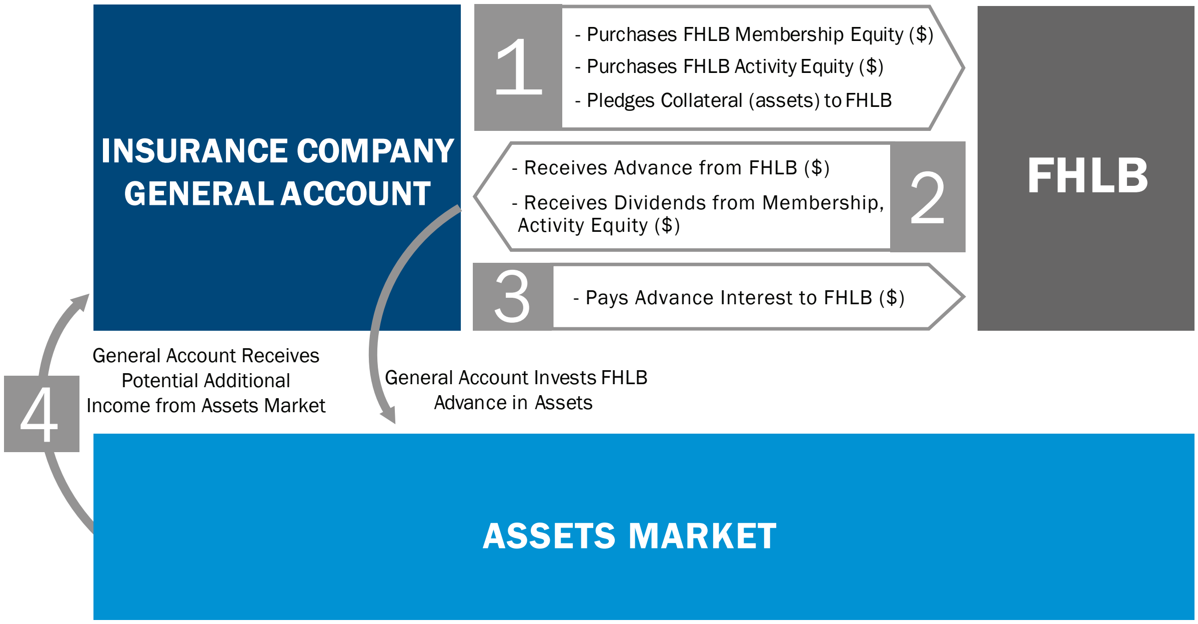
To access FHLB funds, or "advances," insurers must also purchase activity stock, based on the amount to be borrowed, and post collateral to back up the loan(s). Each FHLB bank then applies its own discounting rate to the value of the collateral, dependent on the collateral's type, quality and tenor.

Across the FHLB system, average collateral discount rates for agency debentures and agency MBS were 95% and 94%, respectively, while for private-label MBS and CMOs and CMBS the rates were 69% and 84%, respectively, at year-end 2020.[2] The choice of assets to post while considering the collateral haircut, yield on those investments, and whether the company would own that investment organically, are all critical considerations.

Another significant factor is the required amount of FHLB equity (membership and activity) and the dividend rates on the different classes of stock. The capital charges on FHLB equity vary by regulatory body and rating agency, as well as by insurance industry segment (life/annuity, property/casualty, health, etc.).

Navigating these variables and weighing the choices can be a complex and time-consuming process, so Conning leverages our long-term relationships with FHLB banks and our proprietary tools and investment framework to assist our clients.

Figure 3 Spread Investing via an FHLB Advance



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Opportunities in "Spread Investing"

Among the uses of FHLB financing is investment arbitrage, also known as "spread investing." Companies borrow from the FHLB at one (lower) rate and invest the proceeds in higher yielding securities, capturing the incremental spread (see Figure 3).

Arbitrage investors need to be mindful of many factors, primarily the cost of capital, the cost of borrowing and the return on investment. Matching the term structure of investments and FHLB advances is common and eliminates one risk that could arise. Figuring out these key variables will help an insurer determine if the expected return on capital and incremental income (net of fees and borrowing costs) is worth the commitment of resources.

In considering the attractiveness of spread investing programs, we focus on two criteria: net spread and return on capital. We calculate them as:

$$\textit{Net Spread} = \textit{Market Yield of Investments} + \textit{Dividend on FHLB Activity Stock} - \textit{Cost of Borrowing} - \textit{Estimated Loss Given Defaults} - \textit{Investment Management Fees}$$

$$\textit{Return on Capital} = \frac{\textit{Incremental Net Yield or Return}}{\textit{Incremental Cost of Capital}}$$

We think companies looking for additional investment income that are not capital-constrained (such as P&C insurers) would benefit more from focusing on net spread and the impact of additional income on pro-forma financials. For companies that are more capital-conscious, such as life insurers, comparing return on capital with other uses of capital tends to be a better measure of value.

In most cases, investments offering higher yields and higher credit quality (resulting in lower capital charges and cost of capital) are going to drive better return on capital for insurers. Given current NAIC rating bands and RBC capital charges, this could present an opportunity to invest in AA- and A-rated securities which carry the same capital treatment as AAA securities. The differential in spread and yield levels between these ratings can be quite significant, especially in structured securities (ABS, CMBS and MBS).

Figure 4 illustrates a hypothetical comparison of two five-year investments in our framework. Lower rated securities, the BBB corporates in this case, are going to have a higher cost of capital. Given the market conditions at the time of the analysis, the A-rated esoteric ABS had a higher net yield (inclusive of fees, default expectations and the expected dividend payment on the FHLB activity stock). Borrowing costs and the terms were the same to match the liability with the asset. All of this leads to a higher net spread and greater return on capital and levels of incremental income for the five-year esoteric ABS.

In our experience, the expected returns on FHLB spread programs can ebb and flow. As interest rates and U.S. Federal Reserve activity change over time, the tradeoffs between a fixed versus a floating-rate matched program can vary significantly. Sector spreads and yields will change as well.

Recent market levels have exhibited that, for capital-sensitive insurers, FHLB advances used to purchase below-AAA-rated structured securities such as esoteric ABS, A-rated CMBS or CLOs have been relatively attractive. Investments in corporates or other segments of the market can also prove attractive on an additional-income basis. Returns and expected increases in net investment income depend on current market conditions, borrowing and dividend rates from an insurance company's local FHLB program, and changes in regulatory requirements.

Figure 4 Hypothetical Comparison of Two $10 Mil. Investments

	Esoteric ABS- A Rated 5 Year	Corporates - BBB 5 Year
Cost of Capital	6.54%	9.79%
Yield Net of Defaults, FHLB Dividends, Fees	2.45%	1.35%
Borrowing Term, Rate	5 years, 0.8%	
Net Spread	1.65%	0.55%
Return on Capital	25%	6%
Incremental Income ($000s)	$135	$55

Prepared by Conning, Inc. for illustrative purposes only.

Conclusion

Given the ongoing pressures insurers face in this period of low interest rates and rising volatility, the FHLB is an additional financial resource insurers may wish to consider. Whether an insurer needs a short-term liquidity backstop or is seeking greater flexibility in devising longer-term strategies, Conning believes the FHLB offers a potential avenue of financial solutions for insurers.

Conning recommends insurance companies consult with investment professionals with access to a wide variety of investment capabilities who can help them consider the benefits to their enterprise and investment strategy from membership in the FHLB and their lending programs. Insurers can look to Conning for help in assessing the benefits and potential risks to their investment strategy and balance sheet from implementing an FHLB program.

Matt 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 insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

Footnotes 1 and 2: Source: ©2021 S&P Global Market Intelligence

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