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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

January 12, 2015

Via Email:

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
400 7th Street, SW
Washington, D.C. 20024

Re: *RIN 2590-AA39 – Notice of Proposed Rulemaking regarding membership requirements in the Federal Home Loan Bank System*

Dear Mr. Pollard:

The National Association of Real Estate Investment Trusts (NAREIT) is the worldwide representative voice for real estate investment trusts (REITs) and publicly-traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance residential and commercial real estate. NAREIT's Mortgage REIT (MREIT) Council ("MREIT Council" or "Council"), which includes both residential and commercial MREITs, advises NAREIT's leadership on MREIT matters.

NAREIT and its MREIT Council welcome the opportunity to comment on the provisions of the Federal Housing Finance Agency's (FHFA) *Notice of Proposed Rulemaking (NPRM) to amend its rules governing membership in the Federal Home Loan Banks (FHLBs).*[1] For the past several months, NAREIT's MREIT Council has engaged in a careful review and analysis of the NPRM and has developed the attached comment letter for consideration by the FHFA.[2]

At the outset, NAREIT's Council wishes to register its support for the FHFA's goal, set forth in the NPRM, of ensuring that the core mission of the FHLB system — financing U.S. residential housing — is honored and its support for the FHFA's efforts, some described in the NPRM, to ensure that the FHLB rules reflect current developments in the mortgage marketplace. In this very same spirit,

[1] 79 Fed. Reg. 54848 (September 12, 2014) (hereinafter the NPRM).
[2] As of the date the NPRM was issued, three NAREIT MREIT Council members had become members of FHLBs, through wholly-owned, state-chartered and -regulated captive insurance subsidiaries, and several other MREIT Council members were exploring possible FHLB membership.

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however, the Council disagrees with the provisions of the NPRM that would effectively render captive insurance subsidiaries of MREITs — real estate finance businesses that are highly aligned with the housing mission of the FHLBs — ineligible for FHLB membership.

To the contrary, NAREIT and the Council strongly believe that, as members of FHLBs, captive insurance subsidiaries of MREITs have and will continue to bring benefits to the FHLBs and enhance the ability of the FHLB system to fulfill its mission in today's housing finance sector. Moreover, as federal government support for residential finance inevitably diminishes, with the contraction of GSE activity and diminishing Federal Reserve support for residential MBS, the benefits of responsible MREIT captive FHLB membership are even greater.

Please feel free to contact me if you would like to discuss our positions in greater detail.

Respectfully submitted,

Steven A. Wechsler
President & CEO

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Each of these MREIT captive insurance subsidiary members of FHLBs is chartered, domiciled and supervised in a state within the district of the FHLB of which it is member, and is in full compliance with all relevant laws and regulations. Importantly, each of NAREIT's MREIT members whose subsidiaries are currently FHLB members or are exploring membership is also an SEC-registered, U.S. stock exchange-listed real estate business dedicated to funding mortgages and/or providing mortgage-related finance for single- and multi-family

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residences in the United States. As such, each of these MREIT parents is an operating business whose purpose – financing single and/or multi-family mortgages – is wholly consistent with the historic mission of the FHLB system. Moreover, to maintain their REIT status, MREITs must comply with regulatory requirements that effectively ensure that their mission will remain consistent with the mission of the FHLB system.[2]

Today, publicly-traded MREITs perform an integral role in the U.S. real estate capital markets by providing financing and liquidity through funding and originating mortgage and mortgage-related loans for residential and commercial borrowers. MREITs have, directly or indirectly, funded millions of U.S. residential properties, including both single-family homes and multi-family units. MREITs have been an especially important source of private sector housing finance capital in the aftermath of the 2007-2008 financial crisis by being continuously active in the Agency Residential Mortgage Backed Securities (RMBS) market, and they have been increasingly involved in the recovering Private Label Security (PLS) sector, which is critical to expanding credit to borrowers who otherwise may not have access to home loan financing.

Because certain distinct features of MREITs may not be broadly understood, Section I of this comment provides background on MREITs and describes how MREITs have become an integral part of the housing finance architecture in the United States. Section II discusses why real estate firms, such as residential MREITs and their subsidiaries, are mission-aligned with the FHLB system. Section III sets forth the Council's observations regarding the administration of the FHLBs' membership and lending procedures. In Section IV, the MREIT Council voices its concerns that the NPRM is likely to constrain access to residential single- and multi-family housing finance at an especially inopportune and important time. Section V sets forth the Council's conclusions and its suggestions of areas that might lead to more tailored amendments to the FHLB membership rules, which it believes would better serve the goals of the FHLB system, without the costs of discouraging the beneficial participation of MREIT captives and similar mission-aligned captives in the FHLB system, which can bring stable private capital to the benefit of the FHLB system.

I. Background on MREITs

REITs were established by Congress in 1960 to enable all American investors to enjoy the benefits of investment in real estate. There are two main types of REITs, generally referred to as equity REITs and MREITs. Equity REITs invest in "bricks and mortar" real estate by acquiring leasable space in properties, such as apartments, shopping malls, office buildings, and other properties, and collecting rents from their tenants. At least 34 countries around the world currently have enacted laws supporting equity REIT structures, which own and operate real estate assets.[3] However, the U.S. MREIT sector is wholly distinctive in its role in supporting

[2] To maintain their REIT status, MREITs must satisfy certain rules set forth under the Internal Revenue Code of 1986, as amended, including rules that (i) require that at least 75 percent of the value of a REIT's total assets be represented by real estate assets, cash and cash items and government securities (so-called "qualifying assets"); and (ii) require that no less than 75 percent of an MREIT's income be derived from such qualifying assets. Internal Revenue Code § 856 *et. seq*.
[3] *EPRA Global REIT Survey* (October 2014).

residential and commercial real estate debt finance. Nearly all of the MREITs that are members of NAREIT's MREIT Council are listed on the NYSE or NASDAQ, allowing a wide range of investors, including individual investors as well as institutions, to purchase shares of the equity securities of MREITs.

MREITs today typically concentrate on either the residential or commercial mortgage markets, although some "hybrid" MREITs operate in both markets and a few "hybrid" REITs own and operate real estate and hold mortgages. Residential MREITs serve the U.S. housing market by funding the acquisition and financing of mortgages and mortgage-related instruments, while some MREITs also originate mortgages and mortgage-related loans. When evaluating investment opportunities, MREITs employ rigorous quantitative and qualitative underwriting and credit evaluation methodologies. MREITs also make use of proprietary models to assess loan characteristics and likely performance under a variety or interest rate and market scenarios.

Risk management is a core function of the MREIT business model, allowing firms to proactively consider and address impacts from changes in economic and interest rate conditions, counterparty credit risk, prepayment risk and liquidity risk on an ongoing basis. MREITs regularly stress-test balance sheets, employing disciplined liability and liquidity risk management together with well-tested hedging strategies to mitigate various portfolio risks on an ongoing basis. Additionally, under new rules implemented pursuant to the Dodd-Frank Act, MREITs are required to clear certain derivative instruments used for hedging purposes through central clearinghouses, including interest rate swaps, further increasing the transparency of their trading operations and liquidity management and supporting broader financial stability.

Residential MREITs

Since 2009, Agency RMBS has overwhelmingly dominated U.S. single family mortgage securitization, and mirroring this development, most residential MREITs today focus on Agency RMBS. However, as noted above, a few MREITs also have significant investments in PLS and others are venturing back into this market as a complement to their Agency RMBS holdings.[4] While Agency MREITs have grown in size and number in recent years, today they hold less than four percent of outstanding Agency RMBS. By contrast banks and other depository institutions hold roughly 23 percent of Agency RMBS; the Federal Reserve holds another approximately 25 percent; mutual funds hold approximately14 percent, and the remainder are held by other governmental bodies, insurance firms, pension funds and other entities.[5]

Commercial MREITs

Commercial MREITs provide financing for many types of commercial real estate, including apartment buildings and other multi-family structures, office buildings and office parks, retail establishments, malls, restaurants, data centers and industrial facilities. They may invest in

[4] NAREIT's MREIT Council commented on the U.S. Treasury Department's June 2014 Initiative to Promote Private Label Mortgage. *See*, Steve Wechsler, NAREIT Comment on the Development of Responsible Private Label Securities (PLS) Market (August 8, 2014).
[5] *Financial Stability Oversight Council Annual Report* (2014), p. 38.

commercial mortgages and commercial real estate loans, as well as both rated and unrated CMBS, mezzanine loans, subordinated securities or construction loans, and may participate in loan securitizations. Commercial MREITs traditionally have proprietary origination platforms and provide financing solutions to various buyers and owners of commercial real estate.

MREITs are a Source of Private Capital for U.S. Housing Finance

Because of their regular access to public capital markets, residential MREITs have been able to serve as an important channel for private-sector capital to help sustain and finance home mortgage markets in the aftermath of the recent financial crisis. Since 2007, MREITs have raised more than $70 billion in permanent capital for deployment in the U.S mortgage markets.

As of July 31, 2014, there were 27 residential MREITs in the FTSE NAREIT All REITs index with an equity market capitalization of $48.3 billion and 13 commercial MREITs with an equity market capitalization of $18.1 billion. Exchange-listed MREITs held a total of $492.4 billion in assets at the end of the first quarter of 2014. Of that amount, $258.8 billion was comprised of Agency assets and debentures.[6] Through their investments in real estate-related assets, MREITs have helped to finance more than an estimated 1.4 million homes in the United States.[7]

The success of MREITs today reflects years of developed expertise in the fundamentals of real estate debt markets: expertise combining rigorous research, valuation, data collection, underwriting and technical analytics, together with a deep understanding of the fiscal, legal and regulatory frameworks within which RMBS and CMBS markets operate.

II. Captive Insurance Subsidiaries of MREITs Can Further the FHLB Housing Mission

Members of the MREIT Council believe that the admission of captive insurance subsidiaries of real estate businesses that are aligned with the mission of the FHLBs will continue to strengthen the FHLB system and thereby expand housing finance credit. In this respect, the Council notes that the concerns set forth in the NPRM, although not fully elaborated or documented, appear to arise more from "form" than "substance." For example, while acknowledging that MREITs "are involved in the residential housing finance markets,"[8] the primary concern expressed in the NPRM is that MREITs are among "certain institutions that are ineligible for Bank membership" and are "using captives as vehicles through which they can obtain Bank advances to fund their business operations."[9]

In addition to noting that the FHLB rules do not prohibit members from accessing advances through subsidiaries or wholly-owned conduits (and indeed several do), the Council respectfully urges the FHFA not to overlook the "substance" here – *i.e.*, the strong mission alignment

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[6] Federal Reserve Board, *Financial Accounts of the United States* (2014).
[7] *Id.*, calculation derived by dividing REIT Agency asset holdings ($258.8 billion) by US Existing Home Sales Median Price ($208,300), utilizing a multiplier estimating an average down payment of 10 percent.
[8] NPRM at p.25.
[9] NPRM at 54853.

between MREITs and the FHLB system. Residential MREITs (as well as many commercial MREITs) are real estate finance businesses created and operated *for the very purpose* of funding residential real estate. Moreover, as public companies, their success in executing on this mission is evaluated by the U.S. capital markets daily.

While the NPRM does not document injury arising from MREIT captives accessing FHLB advances, it does suggest that somehow the captive structure could result in advances being used for purposes not related to the FHLB mission. Of course, such a concern (*i.e.*, that because money is fungible, advances might be supporting non-housing activities and be used like a working capital facility would apply to any FHLB member category), least applies to captives of residential MREITs, which are businesses *necessarily* devoted to residential housing finance. Indeed, insurance captives and their MREIT parents use FHLB advances to support the purchase of mortgage loans and securities that fund millions of single- and multi-family homes, which is an activity that is entirely consistent with the FHLB mission to "enable the Banks to provide low cost wholesale funding to their member institutions so that, in turn, those members could provide long-term home mortgage loans to consumers at a reasonable cost" and "to reserve the benefits of Bank membership…for institutions that are likely to use those benefits to fulfill the primary purposes of the Bank Act."[10]

It is also worth noting that Congress has never considered eliminating captive insurance members of the FHLBs, nor has it ever considered distinguishing among insurance structures or curtailing insurance members in any other way, despite multiple opportunities at those times when the Federal Home Loan Bank Act (the FHLB Act) has been amended.[11] Congress has, however, at times, recognized the need to conform FHLB rules to accommodate certain new housing finance products and businesses that have emerged in the decades since the FHLB Act's enactment and support the FHLB mission. But in doing so, Congress has always expanded, rather than contracted, the system's membership opportunities, adding, for example, Community Development Financial Institutions (CDFIs) and thrifts to reflect the evolution in housing finance in the decades since the enactment of the FHLB Act.

III. FHLBs Prudently Administer Membership and Lending Practices Related to Captive Members

The FHLB System and its regulator currently employ stringent, well-designed vetting and control processes for applicants. The MREIT captives that have explored or been granted admission to the FHLB System have found the thoroughness of FHLB credit analysis, underwriting and other activities to be on par with that of the most exacting investors and outside auditors.

[10] *Id*.
[11] *Housing and Economic Recovery Act of 2008 ("HERA*") Pub. L. 110-289 § 1201, 122 Stat. 2654 (2008), codified at 12 U.S.C. § 4513. *Financial Institutions Reform, Recovery, and Enforcement Act of 1989* (Pub. L 101-73 § 709, 013 Stat. 183, 12 U.S.C. § 1424 (1989)) and Gramm-Leach-Bliley Act of 1999 (Pub. L. 106-102 § 604, 113 Stat. 1338, 12 U.S.C. § 1430 (1999)).

FHLB Credit and Collateral Due Diligence

The FHLB membership admission process begins with extensive due diligence screenings performed according to the specific requirements of the FHLB Act and the rules implementing it. The applicant captive's financial data is then subjected to additional credit analysis, consistent with credit underwriting standards in the financial sector. Even in the preliminary stages of the process, the FHLB credit departments analyze and evaluate the management, business activities, historical performance, leverage, capital base and overall stability of each FHLB applicant, and, where applicable, its parent firm.

The FHLBs additionally set strict collateral eligibility requirements to protect each FHLB Bank and the FHLB system as a whole against risk. Moreover, these requirements are rigorously applied and reviewed.

Monthly, Quarterly, and Annual Reporting Requirements

The diligence performed by FHLB credit departments does not stop once an eligible institution is granted membership. Ongoing monitoring and credit review processes continue to confer multiple layers of protection to the FHLBs and their members. Captive insurance members are required to provide monthly, quarterly and annual information relating to both the captive entity and its parent. Reports include, but are not limited to, audited and unaudited financial statements of the parent entity, portfolio details, funding structures and counterparty information and REIT testing results.

Additionally, the structure of the FHLBs, a grouping of member cooperatives, provides additional protection. Upon admission to one of the FHLBs all members, including captives, are required to purchase shares conferring a vested interest in the welfare of the Bank. Members are also required to purchase "activity" stock that is directly correlated to the dollar volume of their borrowings. Activity stock effectively provides an incremental safety tool (on top of collateral haircuts) to align incentives between borrowing and managing system-wide risk by effectively requiring more "skin in the game" as borrowings increase.

The Council fully supports the FHFA's goal of ensuring responsible administration of the statutory membership requirements of the FHLB system. However, after studying the NPRM, and reviewing the recent experiences of Council members and others, the Council notes the thoroughness and competence of current standards and their consistency with credit review performed by other private sector lenders.

IV. If Adopted, the NPRM Would Exacerbate Tightness in U.S. Mortgage Markets

Today, in the aftermath of the financial crisis, there are many differing views as to the proper role of the federal government in a post-GSE conservatorship world. However, there is nearly universal agreement among policy experts, academics and government officials from both political parties that "… there is too little private capital available for housing finance and too few private sector firms with the ability, expertise, experience and capital to effectively stabilize

and expand the sector,"[12] and that federal government policy must "encourage private capital to take a bigger role in the mortgage market."[13] Treasury Secretary Jack Lew recently reaffirmed this consensus observing that "[t]he fact is, we need to attract more private capital to the housing market."[14]

Current market conditions have exacerbated the need to expand private capital funding for housing finance. Housing credit remains very tight notwithstanding recent policy initiatives, limiting residential housing options and constraining the U.S. economy's overall growth trajectory. Fannie Mae and Freddie Mac (GSEs), although still in conservatorship status, are winding down their portfolios through amortization and asset sales, pursuant to the FHFA's strategic plans and goals. Additionally, the Federal Reserve has ended its purchases of RMBS under its quantitative easing program and is evaluating strategies for an eventual unwinding of these holdings. As a result, U.S. Government support for residential mortgage finance appears to be on a trajectory to shrink significantly for the first time in decades. Residential MREITs, many of which are specialists in Agency RMBS and in command of highly sophisticated models, analytics and long institutional expertise, stand ready to inject additional liquidity into this changing mortgage market.

MREITs emerged from the financial crisis as well-capitalized vehicles to access and deploy private capital into the single- and multi-family residential mortgage sectors. The sector has contributed broadly to housing affordability for consumers by originating mortgage loans, purchasing mortgage-backed securities, and providing first loss capital for new private label securitizations. MREITs have also purchased a large portion of the innovative credit risk transfer securities issued recently by the GSEs, a novel approach developed as part of the FHFA's initiative to reduce taxpayer risk in the residential mortgage market. Yet the NPRM, by ultimately barring MREIT captive insurance subsidiaries from FHLB membership, would serve to discourage this trend, and do so at a time when the need for more private housing finance capital is regarded by nearly all stakeholders as urgent.

Today, only a few MREITs may access FHLB funding through their captive insurance subsidiaries. However, the early experiences of these few convey the significant impact that FHLB membership could have, as well as the tangible costs of barring from membership MREIT captive insurance companies. FHLB advances have already provided MREIT captive insurance members and their parent firms with an optional, additional and complementary funding source, generally with longer durations and a different risk profile. This additional source of funding has enhanced the ability of these MREITs to manage their balance sheets responsibly through a

[12] House Financial Services Chairman Jeb Hensarling (R-TX), Press Conference introducing the *PATH Act to a Sustainable Housing Finance System for the 21st Century (August 7, 2013)*.
[13] Id.
[14] *Remarks of Secretary Lew at the Making Home Affordable Five-Year Anniversary Summit* (June 6, 2013). See also, *Remarks of Under Secretary Miller at the National Housing Conference Annual Policy Symposium* (June 13, 2014) ("[acknowledging the outsized role of government in the housing sector… the President called for a return of private capital to the center of the system;" and U.S. Treasury Department and U.S. Department of Housing and Urban Development *Reforming America's Housing Finance Market: A Report To Congress* (there is a need to "help bring private capital back to the market.").

range of market scenarios and has expanded their mortgage funding capacity. This is true even though FHLB advances now constitute a modest percentage of the liabilities of these MREITs and are likely to continue as such for the foreseeable future.

Indeed, the early experiences of the MREITS that have been able to access FHLB funding tell a relatively simple story: access to FHLB advances expands the current and future ability of MREITS and their captive insurance companies to fund U.S. single- and multi-family housing. Also, this pool – captive insurance subsidiaries – of potential FHLB members has the potential to enable the FHLBs to increase their earnings and expand their role in sponsoring affordable housing, as per their mandate.

The Council's members believe that the consequences of restricting FHLB membership by barring MREIT captive insurance companies – and by extension, captives of other potential members with the expertise, ability and capital to responsibly expand private sector housing finance – are likely to be negative, immediate and irreversible.

V. Conclusions and Recommendations

In preparing this comment, NAREIT's MREIT Council spent several months reviewing the NPRM, relevant sections of the FHLB Act and the FHLBs' current administration of the various rules governing the FHLB system and assessing the recent experiences that some Council members have had with the FHLB system. At the conclusion of this process, the MREIT Council did not agree with the FHFA that a valid public policy rationale had been established for the provisions of the NPRM that would effectively bar captive insurance subsidiaries of MREITs from membership consideration by FHLBs, nor that a compelling safety and soundness basis for such a radical change in FHLB membership rules had been established. To the contrary, the Council's conviction that MREITs are highly aligned with the housing mission of the FHLBs and that their participation in the system would benefit its membership and the system as a whole was even stronger.

At the same time, the Council wishes to express its strong support for the FHFA's goal, expressed in the NPRM, of ensuring that the core mission of the FHLB system – financing U.S. residential housing – is honored. The Council also strongly supports the FHFA's efforts to ensure that the FHLB rules reflect current developments in the mortgage marketplace, and endorses the suggestion set forth in the NPRM that the relevant regulatory definition of mortgages be updated to encompass new mortgage products.[15] In this same spirit, the Council urges the FHFA to recognize that MREITs, residential finance businesses that also reflect

[15] The Council would like to register its support of the FHFA's recommendation, also contained in the NPRM, "that it is appropriate to expand the definition of 'home mortgage loan'" to include "all types of MBS backed by qualifying assets and eliminate the current distinction that the rules draw between pass-through securities and other types of MBS," including "collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and other non-pass-through MBS ...[t]he economic interest of all such instruments is much the same, and the forms of the respective instruments are more of a legal technicality that is neither decisive as to the nature of the economic interest that the owner holds nor the level of support for the mortgage market that the securities provide." NPRM at pp. 28-29.

developments in the evolving housing finance landscape, have considerable potential to be strong contributing members of the FHLBs, via captive insurance subsidiaries.

The Council respectfully suggests that a variety of more targeted amendments to the FHLB membership rules could better accomplish the goals set forth in the NPRM without taking the radical step of discriminating among types of insurance firms and effectively proscribing the beneficial participation of mission-aligned MREIT captive insurance subsidiaries.

For example, if the FHFA's concern is that FHLB advances to captive members could be misdirected to purposes unrelated to FHLB mission, the Council suggests that the FHFA might consider developing various membership criteria applicable to the parent of a captive member to ensure that the parent firms are mission-aligned and demonstrate requisite links to the housing finance and community development mission of the FHLB system.

Alternatively (or additionally) if the FHFA wishes to ensure that the links between parent firms and their captive subsidiaries remain sufficiently robust to protect the FHLBs under a variety of scenarios, the FHFA could address this concern more directly and efficiently by developing standard guarantees for parent firms of captive FHLB members.

Finally, if the FHFA's concerns relate to risk management practices, there are a variety of specific reforms that might ensure that captive members and their parents remain focused on risk management at far lower cost, including possibly establishing or reinforcing FHLB institutional or system-wide risk management oversight.

* * *

The potential for residential MREITs and their captives to foster the FHLB mission has been acknowledged by prominent housing policy experts, including Dr. Michael Stegman, the Housing Counselor to Treasury Secretary Jack Lew, who recently observed that "many of the activities that REITs engage in appear to be aligned with the FHLB System's core mission, and represent an important source of private capital that should be at the core of the U.S. housing finance system."[16] The Council respectfully asks that the FHFA not overlook or underestimate the considerable opportunities that MREITs offer to the FHLB system and to private sector housing finance more broadly.

The members of NAREIT's MREIT Council appreciate the opportunity to express their views on the NPRM and their continued support for the FHLB system. If unimpeded by the prohibitions in the NPRM, the Council is confident that MREIT captive insurance members will continue to contribute additional capital, housing finance expertise and diversity to the FHLB membership base, helping to sustain the success of the FHLB system as it adapts, as it must, to an environment becoming progressively less reliant on the historic GSE infrastructure.

[16] *Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman before The North Carolina Bankers Association 2014 American Mortgage Conference* (September 9, 2014).

If you have any questions or you would like to discuss these matters further, please contact NAREIT's Senior Vice President, Policy & Regulatory Affairs, Victoria Rostow, at vrostow@nareit.com or (202) 739-9400.

Respectfully submitted,

Executive Committee
NAREIT MREIT Council

NAREIT MREIT Executive Committee Chair:
William S. Gorin
Chief Executive Officer
MFA Financial, Inc.

MREIT Council Executive Committee Members:

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Chairman & CEO
Hatteras Financial Corporation

Andrew F. Jacobs
President & CEO
Capstead Mortgage Corporation

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