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(2) *Private Citizen member.* The Office of Finance shall pay compensation and expenses to the Private Citizen member of the OF board of directors in accordance with the requirements for payment of compensation and expenses to Bank directors set forth in § 932.17 of this chapter, except that, for these purposes:

(i) The Office of Finance policy on director compensation must be approved by the board of directors of the Finance Board;

(ii) Section 932.17(a)(3) and (c)(1)(ii) of this chapter shall not apply; and

(iii) The terms "average compensation per director" and "ACPD," as used in § 932.17 of this chapter, shall be deemed to mean "maximum compensation of the Private Citizen member".

Dated: October 28, 1998.

By the Board of Directors of the Federal Housing Finance Board.

Bruce A. Morrison,

Chairperson.

[FR Doc. 98-31786 Filed 11-27-98; 8:45 am]

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FEDERAL HOUSING FINANCE BOARD

12 CFR Parts 938 and 943

[No. 98-49]

RIN 3069-AA61

Federal Home Loan Bank Standby Letters of Credit

AGENCY: Federal Housing Finance Board.

ACTION: Final rule.

SUMMARY: The Federal Housing Finance Board is codifying its existing policy on Federal Home Loan Bank (FHLBank) standby letters of credit (LOCs) in a regulation and amending the policy to allow for broader use of standby LOCs by FHLBank members and eligible nonmember mortgagees. This final rule also eliminates or modifies some of the restrictions currently imposed on standby LOCs issued or confirmed by FHLBanks that limit the usefulness of these products to members and eligible nonmember mortgagees.

DATES: This final rule is effective on December 30, 1998.

FOR FURTHER INFORMATION CONTACT: Diane E. Dorius, Associate Director, Program Development, Office of Policy, (202) 408-2576; or Eric M. Raudenbush, Attorney-Advisor, Office of General Counsel, (202) 408-2932, Federal Housing Finance Board, 1777 F Street, NW, Washington, DC 20006.

SUPPLEMENTARY INFORMATION:

I. Background

On May 8, 1998, the Federal Housing Finance Board (Finance Board) published, and requested public comments on, a proposed rule to add to its regulations a new part 938, governing the issuance and confirmation of standby LOCs by FHLBanks. See 63 FR 25726 (May 8, 1998). The rulemaking proposed to amend the Finance Board's existing policy on FHLBank standby LOCs to provide the FHLBanks with greater flexibility to respond to member needs for these products in a manner that would be consistent with the FHLBank System's housing and community investment mission, and to codify the amended policy into regulatory form.

The ninety day public comment period closed on August 6, 1998. The Finance Board received a total of 24 comments: eleven from FHLBanks, two from FHLBank Advisory Councils, eight from trade associations, and one each from an executive agency of the U.S. Government, a FHLBank member, and a private law firm. The FHLBanks that commented generally supported the proposed rule. The executive agency, FHLBank member and several trade associations opposed the rule.

The proposed rule established uniform standards for the issuance of standby LOCs that addressed eligible purposes, collateral requirements, nonmember use of LOCs, maturity limits, FHLBank capital stock, and other policy requirements. The purpose of the proposal, and of the final rule, is to provide the FHLBanks with greater flexibility and discretion, consistent with safe and sound operation, than exist under the Finance Board's current Interim Policy Guidelines for FHLBank Standby LOCs (Interim Guidelines).

Specifically, the Finance Board proposed that the enumeration of specific permissible uses for FHLBank LOCs that is set forth in the Interim Guidelines be replaced with a provision authorizing the FHLBanks to issue or confirm standby LOCs for any of four general purposes: to assist members in facilitating residential housing finance; to assist members in facilitating community lending (so-called in the final rule, this was referred to as "targeted economic development" in the proposed rule); to assist members with asset/liability management; and to assist members with liquidity and other funding.

The proposed rule permitted FHLBanks to issue and confirm standby LOCs on behalf of nonmember borrowers for the same purposes as

members if such LOCs were secured by Federal Housing Administration (FHA) insured loans or Government National Mortgage Association (GNMA) securities backed by FHA loans. Under the proposed rule, FHLBanks could issue or conform standby LOCs on behalf of nonmember borrowers that are state housing finance agencies (SHFAs) for residential or economic development lending that benefits individuals or families meeting the income requirements in sections 142(d) or 143(f) of the Internal Revenue Code, 12 U.S.C. 142(d), 143(f), if these LOCs were secured by collateral with which an SHFA may secure advances under section 10B(b) of the Federal Home Loan Bank Act (Bank Act). 12 U.S.C. 1430b(b).

Under the proposed rule, all LOCs were required to be fully collateralized at the time of issuance by collateral eligible to secure advances to members (or, as appropriate, nonmember mortgagees) and, in the case of standby LOCs issued or confirmed on behalf of members for housing or community lending purposes, also by certain other high-quality collateral. Unlike the existing Interim Guidelines, the proposed rule neither required nor permitted outstanding LOCs to be taken into account in the computation of a member's advances-to-FHLBank capital stock ratio.

Finally, the proposed rule required that: LOCs have a specific expiration date or be for a definite term; LOC renewals be conditioned upon the member/applicant meeting the FHLBank's credit criteria at the time of renewal; and the FHLBank issuing an LOC would approve any transfer of the LOC.

The final standby LOC regulation remains unchanged on most substantive points from the rule as proposed, although the Finance Board has made several amendments for purposes of clarity and in order to make the regulation conform to the final Community Investment Cash Advances (CICA) regulation, (published in the November 27, 1998 edition of the **Federal Register**), to which the community lending provisions of the rule are tied. These changes are described in detail below. Also provided below are clarifications of certain issues that were raised in the comment letters.

II. Statutory Basis for FHLBank Standby Letter of Credit Authority

Nine commenters explicitly addressed the statutory authority of FHLBanks to issue and confirm LOCs pursuant to the terms set forth in the proposed rule.

Three of these (two FHLBanks and one trade association) expressly supported the view that, under the Bank Act, 12 U.S.C. 1421-49, FHLBanks have such statutory authority. Six commenters (one FHLBank member, the executive agency and four trade associations) questioned the statutory bases underlying the proposed rule. Two of the trade associations, in letters that were nearly identical, queried whether the FHLBanks have statutory authority to issue standby LOCs under any circumstances. The Finance Board has reviewed the legal reasoning underlying the provisions of the proposed rule and has concluded that there is ample authority under the Bank Act to permit the FHLBanks to issue and confirm standby LOCs under the terms of the final rule.

A. Legal Determinations of the FHLBB Regarding FHLBank LOCs

Although the Bank Act does not expressly address LOCs, the FHLBanks have been explicitly permitted to engage in standby LOC transactions since 1983, when the predecessor agency to the Finance Board, the former Federal Home Loan Bank Board (FHLBB), first adopted Policy Guidelines for Issuance of FHLBank Standby Letters of Credit (FHLBB Policy). Underlying the adoption of the FHLBB Policy was an opinion rendered by the FHLBB General Counsel that, because a FHLBank standby LOC is the functional equivalent of a loan between the FHLBank and its member, FHLBanks have authority to issue standby LOCs as part of their power to make advances under section 10 of the Bank Act, 12 U.S.C. 1430, provided that the member has the unconditional obligation to reimburse the FHLBank for any payment made thereunder. As an alternative, the FHLBB further concluded that the issuance by a FHLBank of a standby LOC on behalf of a member and payment by the FHLBank of a draft presented by the beneficiary thereunder is incidental to a FHLBank's payment instrument processing authority under section 11(e)(2) of the Bank Act, 12 U.S.C. 1431(e)(2), so long as the disbursement process under the LOC is directly linked to the member's FHLBank demand deposit account. However, having relied on the section 10 advances authority as its primary rationale, the FHLBB imposed upon each FHLBank standby LOC at the time of issuance all statutory requirements that applied to outstanding advances, including requirements as to capital stock ratio and purchase, purpose and collateral. (The Finance Board later permitted FHLBanks to issue standby

LOCs on behalf of eligible nonmember mortgagees pursuant to the FHLBanks' section 10b advances authority. See 12 U.S.C. 1430b.)

After numerous requests over a period of years from several FHLBanks, the Finance Board undertook a comprehensive legal and policy review of the Interim Guidelines in order to determine whether any of these advances-related restrictions could be eliminated, so as to make FHLBank LOCs more useful to their members and eligible nonmember mortgagees. As a result of its legal review, the Finance Board's Office of General Counsel (OGC) determined that, while the legal authority for issuing LOCs articulated in the original FHLBB legal analysis remains valid, it is not necessary to view a LOC as an outstanding advance at the time the LOC is issued, nor is it necessary as a matter of law to subject LOCs to all of the statutory restrictions and limitations that apply to outstanding advances. OGC concluded that the authority to engage in standby LOC transactions also arises from the FHLBanks' authority to accept deposits and process payments under section 11(e) of the Bank Act, 12 U.S.C. 1431(e), and from their incidental authority to enter into commitments to make advances under sections 9, 10(a), and 11(a) of the Bank Act. *Id.* 1429, 1430(a), 1431(a).

B. FHLBank Deposit Taking and Payment Processing Authorities

Section 11(e)(1) of the Bank Act authorizes each FHLBank to accept deposits from members, upon such terms and conditions as the Finance Board shall prescribe. *Id.* 1431(e)(1). In addition, section 11(e)(2)(A) authorizes the Finance Board to permit FHLBanks, among other things, to be drawees of drafts drawn on members of any FHLBank and to have such incidental powers as the Finance Board shall find necessary for the exercise of such powers. *Id.* 1431(e)(2)(A).

A FHLBank that has issued a standby LOC on behalf of a member would be the drawee of—that is, the financial institution directed to make payment upon—any draft presented to it thereunder. Although the funds paid by a FHLBank to a beneficiary pursuant to a LOC draft technically are considered to be paid from the FHLBank's own funds, a LOC draft may be regarded as being drawn on the member's deposit account at the FHLBank where: (1) The FHLBank maintains an absolute right, either by contract or operation of law, to offset the member's FHLBank deposit account in the amount of the LOC draft; and (2) the member assumes an absolute

obligation to the FHLBank to have available in its account sufficient funds to cover the amount of the LOC draft at the time of the FHLBank's payment thereon. Because a primary purpose of a standby LOC is to transfer the risk of default by the applicant from the beneficiary to the issuer, it is consistent with the reality of a standby LOC transaction to consider payment on a LOC draft to result in a draw on a member/applicant's deposit account. These requirements have been imposed upon FHLBank LOC transactions since they were first permitted in 1983 and, in commercial practice, are common to standby LOC transactions generally.

The plain language of section 11(e)(2) makes clear that the Finance Board's powers to authorize FHLBank activity thereunder is to be interpreted broadly, empowering the Finance Board both to implement definitions of terms used therein and to permit the FHLBanks to engage in such incidental activities as the Finance Board finds necessary for the exercise of any authorities thereunder. See *id.* 1431(e)(2)(A). The legislative history of section 11(e)(2) also stresses the broad range of activities that may be authorized thereunder, explaining that "it is important that the [FHL]Banks have the ability to service the broad and evolving financial service needs of members." H.R. Rep. No. 842, 96th Cong., 2nd Sess. 74 (1980). Given this expansive language, and considering that section 11(e)(2) contains no limitation as to the subject matter of the transaction of which the draft is a part, section 11(e)(2) permits the Finance Board to authorize FHLBanks to act as drawee on drafts drawn on a member's FHLBank deposit account as part of a standby LOC transaction.

Regardless of the purpose for which a standby LOC is issued, the sole substantive undertaking by the issuer is to honor any conforming draft that is presented by the beneficiary. All other apparent aspects of a standby LOC transaction are merely by-products of this central obligation. For example, while one might characterize the issuance of a standby LOC as a guarantee of the applicant's obligation, or as a lending of credit to the applicant, such characterizations are merely means of describing the effect of the issuer's agreement to honor a conforming draft presented by the beneficiary. In that, under section 11(e)(2) of the Bank Act, the Finance Board may authorize FHLBanks to execute this central obligation by making payment on a conforming draft presented by the beneficiary, the power to agree to undertake such an obligation (by

contracting therefore with the member) and the power to undertake the obligation (by issuing the standby LOC) are well within the FHLBanks' incidental authority to engage in activities necessary to facilitate the exercise of the FHLBanks' authority to make payment on the LOC draft. Accordingly, under both the express terms and the incidental powers clause of section 11(e)(2) of the Bank Act, the Finance Board is authorized to permit FHLBanks to contract with members to issue standby LOCs, to issue standby LOCs, and to honor conforming drafts presented by a beneficiary pursuant to a standby LOC issued by a FHLBank.

C. FHLBanks' Incidental Power To Enter Commitments To Make Advances

While the Finance Board has concluded that section 11(e) provides sufficient independent authority to permit a FHLBank to engage in a standby LOC transaction, it has not rejected the FHLBB's position that such activity is also authorized as part of the FHLBanks' statutory advances powers. However, the Finance Board has concluded that, in applying the statutory advances provisions to a standby LOC transaction, a standby LOC is characterized more logically as a form of advance commitment than as an outstanding advance. Section 9 of the Bank Act authorizes any FHLBank member to apply in writing for advances. See 12 U.S.C. 1429. In turn, section 10(a) authorizes each FHLBank to extend to members advances that are fully secured at the time of origination or renewal by a security interest in one or more of the types of eligible collateral that are listed in that section. See *id.* 1430(a). In addition to these express powers, section 11(a) of the Bank Act authorizes the FHLBanks to do all things necessary for carrying out the provisions of the Bank Act and "all things incident thereto." See *id.* 1431(a).

D. Legal Authority for Nonmember LOCs

Because the power to enter into a contractual commitment to extend an advance is convenient and useful in connection with the FHLBanks' express authority to make advances and to accept applications for advances, such power is incidental to both of these express authorities. A standby LOC is a form of advance commitment in that both may: (1) Involve the FHLBank entering into an obligation, intended to benefit its member, to disburse funds at some future date; (2) require reimbursement by the member in the event that the commitment to fund is exercised; and (3) result in an advance. The proposed regulation further tied

standby LOC authority to the FHLBanks' power to enter into advance commitments by authorizing the FHLBanks to issue standby LOCs only when: (1) the member has assumed an unconditional obligation to reimburse the FHLBank for any amounts paid to the beneficiary pursuant to a LOC draft; and (2) prior to agreeing to issue a standby LOC, the FHLBank performs the same type of credit analysis of the member that would occur before entering into a traditional commitment. Accordingly, the FHLBanks' incidental power to enter into commitments to make advances provides an alternative source of authority for the FHLBanks to engage in standby LOC transactions.

Because the FHLBanks' express deposit taking and payment processing authorities set forth in section 11(e) of the Bank Act apply only to dealings with members and those eligible to make application to become members, the power of the FHLBanks to issue standby LOCs on behalf of nonmember mortgagees arises only from the FHLBanks' authority, detailed in section 10b of the Bank Act, 12 U.S.C. 1430b, to make and to commit to make advances to nonmember mortgagees. Because the Finance Board cannot authorize the FHLBanks, as part of this payment processing power, to be a drawee on a draft drawn on the deposit account of a nonmember, the provisions of the proposed rule authorizing FHLBanks to issue standby LOCs on behalf of nonmembers is grounded entirely in the FHLBanks' powers to make advances to nonmember mortgagees and to enter into commitments to make such advances.

III. Comments on Proposed Rule and Analysis of Changes Made in Final Rule

A. Definitions

Section 938.1 of both the proposed and final rules set forth the definitions of terms used in part 938. One of the purposes for which FHLBank members, and certain nonmembers, may issue standby LOCs under both the proposed and final rules is to assist members in facilitating the financing of community lending eligible for any of the FHLBanks' CICA programs under part 970 of the Finance Board's regulations. Because, at the time that the proposed LOC rule was published, the CICA regulation had not been codified as a final rule, the Finance Board included definitions of all CICA-related terms explicitly in the proposed LOC rule for purposes of clarity. However, because the Finance Board has now promulgated a final CICA rule, the Finance Board has removed most of the CICA-related

definitions from the final LOC rule and has merely cross-referenced the CICA regulation, where appropriate.

The one remaining CICA-related term that is set forth in § 938.1 is "community lending," which is intended to refer to non-housing activities addressed in the CICA regulation. In the proposed LOC rule, these activities were referred to as "economic development projects that would benefit families with incomes at or below a targeted income level" (the individual terms in this phrase were each defined separately in the proposed rule). This terminology has been changed in the final LOC rule so that it remains consistent with that used in the CICA regulation. Aside from the elimination of the CICA-related definitions and the substitution of the term "community lending," § 938.1 remains unchanged in the final rule.

B. Purposes for Which a FHLBank May Issue or Confirm a Standby LOC

Sections 938.2 and 938.3 of the proposed and final rules govern FHLBank issuance and confirmation of standby LOCs on behalf of members and eligible nonmembers, respectively. Sections 938.2(a) (1)–(4) set forth the four general purposes for which a FHLBank may issue or confirm a standby LOC on behalf of a member, while §§ 938.3(a) (1)–(4) enumerate the same four general purposes with respect to standby LOCs issued or confirmed on behalf of eligible nonmember mortgagees that are not SHFAs. In the final rule, both § 938.2(a)(2) and § 938.3(a)(2) have been amended to refer to community lending that is eligible for any of the FHLBanks' CICA programs under part 970 of the regulations, as opposed to "economic development projects that benefit families with incomes at or below a targeted income level." This was done in order to make clear the connection between the LOC and CICA regulations, to eliminate the need to address in the LOC regulation terms of art that are defined in detail in the CICA regulation and, as explained above, to conform to the terminology used in the final CICA rule.

Although this amended wording was not intended to result in a substantive change, changes made to the community lending (*i.e.*, non-housing) provisions of the CICA regulation in the final CICA rule have resulted in a slightly altered scope for both §§ 938.2(a)(2) and 938.3(a)(2) in the final standby LOC rule. These changes, as well as comments received regarding the scope of what is now termed "community lending," are addressed in detail in the preamble to the final CICA rule.

Four commenters (the executive agency and three trade associations) criticized the enumerated purposes for which FHLBanks would be permitted to issue or confirm standby LOCs. All four commenters expressed concern that the breadth of the proposed purposes would allow the FHLBanks to finance, with government subsidized funds, a wide array of economic activities and other transactions that may have little or no relation to the FHLBank System's mission. All four also stated that the Finance Board had failed to show that expanding the FHLBanks' authority to issue LOCs is necessary to overcome a market failure and that the regulation appeared to allow the FHLBanks to intrude into private markets for credit enhancements by unfairly taking advantage of their funding subsidy to supplant, rather than supplement, the role of private sector financial services providers. Two of the trade associations and the executive agency also stated that FHLBank LOCs will serve merely as a substitute for advances.

There exists no statutory provision that limits the FHLBanks to providing to their members and eligible nonmembers only those products or services for which there has been a failure of the market. Moreover, the FHLBanks have been issuing LOCs on behalf of members since 1983, and on behalf of nonmember mortgagees since 1993, and such issuance has not resulted in a diversion of attention or funds from the FHLBanks' advances programs. Although a FHLBank LOC technically could be structured so as to serve as a substitute for an advance, there are many instances where it is more logical to provide a LOC to support a particular transaction than an advance. For example, a LOC may be issued to support the issuance of bonds, to guarantee a member's performance in a swap transaction, or to secure public unit deposits. The use of an advance to support any of these transactions would be both cumbersome and not in keeping with modern business practices. The Finance Board's decision to permit FHLBanks to issue or confirm LOCs for such purposes, and for asset/liability management and liquidity purposes generally, is in keeping with Congress's expressed desire to allow the FHLBanks to service the broad and evolving financial service needs of their members. See H.R. Rep. No. 842, 96th Cong., 2nd Sess. 74 (1980); 108 Cong. Rec. H4994 (daily ed. Aug. 3, 1989) (statement of Rep. Garcia).

The only truly new use that has been authorized for FHLBank LOCs under the proposed and final rules is for CICA-defined community lending activities,

which clearly is consistent with the System's housing and community lending mission, and is expressly mentioned in the Bank Act as an authorized use of advances. See 12 U.S.C. 1430(j)(10). Even this authorization is not a wholesale departure from past practice, as the FHLBanks have been permitted since 1993 to issue LOCs to support targeted economic development activities under their Community Investment Programs. In addition, by permitting only mission-related LOCs to be secured by collateral that would not be eligible to secure advances (discussed more thoroughly below), the Finance Board is encouraging the FHLBanks to concentrate on providing LOCs to support mission-related activities.

C. Collateral for Standby LOCs

1. Full Collateralization

Sections 938.2(b) and 938.3(b) of the proposed rule, addressing collateralization of member and nonmember LOCs, respectively, required that all LOCs be fully collateralized at the time of issuance. The Finance Board specifically requested comment on: (1) Whether there are any circumstances under which the FHLBanks could safely and soundly issue LOCs that are not fully collateralized; and (2) whether there are other assets, in addition to those enumerated in the proposed rule, that should be considered as eligible collateral for LOCs and whether the Finance Board should establish limits on these additional types of collateral. Three FHLBanks supported continuing to require full collateralization of LOCs and stated that they were unaware of any circumstance where less than full collateralization would be appropriate or prudent. These FHLBanks also stated that they believed the expanded types of collateral provided sufficient flexibility to members and that maintenance of the AAA rating of each FHLBank and the FHLBank System as a whole far outweighed any possible perceived benefit to permitting issuance of less than fully secured LOCs.

Three FHLBanks supported giving the FHLBanks the authority to issue LOCs that are not fully collateralized. One FHLBank stated that commercial banks issue unsecured LOCs based on their credit underwriting and their assessment of the business relationship with the applicant and that FHLBanks similarly should be permitted to use their business judgment in determining the assets it will accept as collateral. Another FHLBank recommended that the FHLBanks be permitted to take into

account the probability of actual loss on a LOC in determining the level of collateralization necessary.

Sections 938.2(b) and 938.3(b) of the final rule continue to require that LOCs issued or confirmed on behalf of members or nonmembers, respectively, be fully collateralized at the time of issuance or confirmation. Requiring that LOCs be fully collateralized at the time of issuance provides protection from credit risk and ensures that a FHLBank is not involved in underwriting the transaction that is supported by the LOC.

2. Collateral Eligible To Secure FHLBank Standby LOCs for Members

Section 938.2(c) of the proposed rule authorized a FHLBank, at its discretion, to accept from members as collateral for LOCs for housing and community lending purposes, in addition to the section 10(a) collateral required for advances: secured or federally guaranteed loans to small businesses; investment-grade obligations of state or local government agencies; and "other real estate-related" collateral in excess of the "30 percent of capital" limitation applicable to such collateral used for advances, see 12 CFR 935.9(a)(4). Sections 938.2(c)(1) and (2) have been amended in the final rule to make clear that standby LOCs that are confirmed on behalf of a member, as well as those that are issued on behalf of a member, must be secured by assets that fall within the enumerated categories of eligible collateral. The words "or confirmed" had been omitted inadvertently from both sections in the proposed rule.

In addition, the last sentence of paragraph (c)(1) has been amended to eliminate reference to "outstanding advances," so as not to imply that an FHLBank standby LOC is, or must otherwise be treated as, an outstanding advance. The first sentence of § 938.2(c)(1) permits the FHLBanks to accept as collateral for standby LOCs any collateral that is eligible to secure advances under § 935.9(a) of the regulations. Under § 935.9(a)(4) of the regulations, and as required by section 10(a)(4) of the Bank Act, 12 U.S.C. 1430(a)(4), a FHLBank may not accept as collateral for advances so-called "other real estate related collateral" in an amount exceeding 30 percent of the borrowing member's capital. See 12 U.S.C. 1430(a)(4), 12 CFR 935.9(a)(4). As discussed above, the Finance Board has concluded that statutory requirements pertaining to FHLBank advances need not be applied to LOCs at the time of issuance. Therefore, as a legal matter, the Finance Board may permit the FHLBanks to accept "other real estate

related collateral” as security for standby LOCs without regard to the statutory “30 percent of capital” limitation that applies to advances, to the extent that the acceptance of such collateral is consistent with the safe and sound operation of the FHLBanks.

However, as a matter of regulatory policy, the Finance Board is permitting FHLBanks to accept “other real estate-related collateral” in excess of the “30 percent of capital” limitation only where the LOC being secured is issued or confirmed for one of the mission-related purposes enumerated in §§ 938.2(a)(1) and (2). This policy is expressed in negative terms in the second sentence of § 938.2(c)(1), which qualifies the presumption that LOCs must be secured by collateral that is eligible to secure advances by stating that only those LOCs that are issued or confirmed for the non-mission-related purposes enumerated in §§ 938.2(a)(3) and (4) are subject to the “30 percent of capital limitation.” In other words, § 938.2(c)(1) requires that the combined amount of advances and outstanding standby LOCs issued or confirmed for purposes enumerated in §§ 938.2(a)(3) and (4) that are secured by “other real estate-related collateral” may not exceed 30 percent of a member’s capital. The intent behind the second sentence of § 938.2(c)(1) is to permit FHLBanks to accept without limitation as security for mission-related standby LOCs—that is, those issued or confirmed to assist members in facilitating residential housing finance or community lending—“other real estate related collateral” referred to in § 935.9(a)(4) of the regulations.

Seven commenters (five FHLBanks and two trade associations) supported the expanded types of eligible collateral identified in the proposed rule. One commenter noted in particular that residential acquisition, development and construction loans that otherwise would be subject to the “30 percent of capital” limitation applied to “other real estate related collateral” have proven to be profitable and performed quite well. In addition, requiring the FHLBanks to establish policies and procedures for valuing and securing this collateral could allay any safety and soundness concerns. Five commenters (four FHLBanks and one advisory council) supported leaving the eligible collateral to the discretion of the FHLBank. Three commenters (the executive agency and two trade associations) opposed expanding the categories of eligible collateral for LOCs.

In the final rule, the Finance Board has retained the collateral requirements that were included in the proposed rule.

Because the Bank Act does not specify the types of collateral that may be used to secure LOCs, the Finance Board has the discretion to specify the eligible types of collateral, consistent with the safe and sound operation of the FHLBanks, and even to authorize the FHLBanks themselves to determine the appropriate types of collateral. The proposed rule identified additional types of collateral that may be used only to finance activities that are clearly linked to the FHLBanks’ mission of supporting housing and community lending. Accordingly, the Finance Board’s determination to allow FHLBanks to accept such collateral is clearly tied to a beneficial public policy goal. In addition, the expanded types of collateral (secured or federally guaranteed loans to small businesses, investment-grade obligations of state or local government agencies and “other real estate-related” collateral in excess of the 30 percent of capital limitation) build upon the experience the FHLBanks currently have in valuing and securing such collateral.

The FHLBanks already are permitted to accept “other real-estate related collateral” to secure LOCs and advances (within the “30 percent of capital” limitation). Thus, the FHLBanks already manage the credit, liquidity and marketability risks, as well as other risks, associated with these types of collateral. There is no evidence that permitting the FHLBanks to accept these types of collateral for LOCs in excess of that which is allowed for advances will subject the FHLBanks to underwriting tasks that are beyond their ability to manage.

With regard to the FHLBanks’ acceptance of small business loans as collateral, the Finance Board requires that the FHLBanks have underwriting expertise and credit policies in place before accepting such loans as collateral. Specifically, § 935.5 of the Finance Board’s advances regulation, 12 CFR 935.5, requires that the FHLBanks establish written procedures for determining the value of collateral and to follow these procedures in ascertaining the value of particular assets used as collateral. This requirement has been applied to LOC transactions in § 938.5(a)(1)(ii) of the proposed and final rules. Under § 935.12 of the regulations, which has also been made to apply to LOCs under § 938.5(b)(2) of the proposed and final rules, the FHLBanks also are permitted to require a member to support the valuation of any collateral with an appraisal or other investigation of the collateral as the FHLBank deems necessary.

The Finance Board is requiring each FHLBank to review its collateral procedures, and amend them as necessary to reflect the changes made in the final rule before accepting any newly authorized assets as collateral for LOCs. The Finance Board also expects that the FHLBanks, as a matter of practice, will conduct careful review and, if necessary, require an appraisal of such collateral, taking into account the additional risks inherent in small business lending and each FHLBank’s own capability to evaluate those risks. In addition, the FHLBanks generally require that members pledge additional collateral if the value of their original collateral declines.

Finally, as the regulator of the FHLBanks, the Finance Board’s primary responsibility is to ensure that the FHLBanks operate in a financially safe and sound manner. See 12 U.S.C. 1422a(a)(3)(A). The Finance Board’s oversight of the FHLBanks includes annual on-site examinations and regular off-site review of FHLBank operations. Emphasis is placed on areas of FHLBank operation that could potentially expose the FHLBank and the FHLBank System to risk. As part of the examination process, the Finance Board reviews and evaluates the FHLBanks’ management of collateral. Examiners review valuation methodology, discounts applied to collateral, and frequency of re-valuation for various types of collateral. In short, the above-described FHLBank practices, regulatory requirements, and Finance Board examination oversight, all serve to ensure that the safety and soundness of the FHLBanks would not be compromised by authorizing the expanded collateral options in the final rule.

3. Collateral Securing Nonmember Standby LOCs

Under § 938.3 of the proposed rule, nonmember borrowers were permitted to secure LOCs with the same types of collateral that they may use to secure advances. Under proposed § 938.3(a), nonmember borrowers (including SHFAs) were permitted to use FHA-insured loans or GNMA securities backed by FHA-insured loans as collateral for LOCs used for any of the same four purposes permitted for LOCs on behalf of members. Under § 938.2(b), a SHFA may secure LOCs with collateral eligible to secure advances under section 10(a) of the Bank Act, 12 U.S.C. 1430(a), provided the LOCs are used to facilitate residential or commercial lending that benefits individuals or families meeting the income requirements in section 142(d) or 143(f) of the Internal Revenue Code.

See 26 U.S.C. 142(d), 143(f). Both of these provisions remain unchanged in the final rule.

Noting that the proposed rule would permit members to use investment grade debt securities of a SHFA as eligible collateral for LOCs, one commenter (a private law firm) recommended that nonmember SHFAs be permitted to obtain LOCs backed only by an investment-grade general obligation of the SHFA, where the obligation is secured by a statutory lien on the SHFA's unencumbered assets. The commenter stated that the ability to combine collateral types (the SHFA's investment grade obligation and the statutory lien, and the option of the mortgage being financed) may be the only way to provide economical tax-exempt financing for housing and economic development projects. While this suggestion has logical merit, as explained above, the Finance Board has concluded that, as a matter of law, LOCs may be issued or confirmed on behalf of nonmembers only under the same conditions that apply to nonmember advances. See 12 U.S.C. 1430b, 12 CFR 935.24. Therefore, under the Bank Act, the Finance Board may not authorize a nonmember SHFA to offer as collateral its general obligation, even under the conditions recommended by this commenter.

D. Additional Provisions Applying to FHLBank Standby LOCs

1. Special Pricing Provisions in FHLBank Standby LOC Policies

In the final rule, § 938.5(a)(1)(iii), regarding pricing criteria that must be set forth in each FHLBank's standby LOC policy, has been amended to cross-reference the codified CICA regulation, thereby eliminating the need to use and define in the LOC regulation terms of that are explained thoroughly in the CICA regulation.

2. Cost of Capital Adjustment Factor

In the proposed rule, the Finance Board requested comments on whether FHLBank fees for LOCs may be subject to a cost of capital adjustment factor under section 11(e)(2) of the Bank Act, 12 U.S.C. 1431(e)(2), given that the FHLBanks' power to make payments upon standby LOCs arises partially from the FHLBanks' payment processing powers. Five commenters (three FHLBanks, one advisory council and one trade association) opposed applying the adjustment factor to LOC fees.

Section 11(e)(2)(B) of the Bank Act requires FHLBanks to make charges for payment processing services provided under section 11(e)(2), including the

payment of drafts, in a manner consistent with the criteria established for pricing of Federal Reserve Bank payment processing under section 11A(c) of the Federal Reserve Act, 12 U.S.C. 248a(c). This statutory requirement has been implemented through part 943 of the Finance Board's regulations, 12 CFR part 943. Specifically, the pricing of services is addressed in § 943.6(b), which requires that the FHLBanks apply a cost of capital adjustment factor to their payment processing charges in order to take into account all direct and indirect costs of such services and the imputed rate of return that would have been earned and the taxes that would have been paid if the FHLBanks were wholly private corporations. See *id.* 943.6(b).

Accordingly, the Finance Board has concluded that, for any draw made by a beneficiary under a standby LOC, the applicant must be charged a processing fee calculated in accordance with the requirements of § 943.6(b) of the Finance Board's regulations. In the final rule, § 938.5(a)(1) has been amended to add a new paragraph (iv) requiring that each FHLBank's standby LOC policy require such a charge. This requirement does not extend to fees, periodic or otherwise, charged to a customer to issue, confirm, or renew a standby LOC.

In addition, in the final rule, the Finance Board has amended § 943.6(c) of its regulations to exempt fees collected for draws upon a LOC from the publication requirement set forth therein. The Bank Act does not require that FHLBank payment processing fees be published in the **Federal Register**.

3. Members' FHLBank Capital Stock

Section 938.5(b)(2) has been amended in the final rule to make clear that the provisions regarding advances collateral that are set forth in § 935.9(d) and 935.10 of the Finance Board's regulations apply also to collateral pledged to secure a FHLBank LOC. Section 935.9(d) of the regulations provides that each FHLBank shall have a lien upon the stock of its members for all indebtedness of the member to the FHLBank. The cross-reference to this section that has been added to § 938.5(b)(2) of the final rule is intended to make clear that each FHLBank shall have a lien upon its member's FHLBank stock for any indebtedness that may result from a draw upon a LOC issued or confirmed by the FHLBank on behalf of that member. This reference is intended only to require a lien on FHLBank stock that the member already owns and should not be read as requiring or permitting a FHLBank to include standby LOCs in the calculation

of its members' capital stock-to-advances leverage ratio. Stock purchase would be required only if and when an LOC is drawn and the FHLBank and its member agree to fund any resulting overdraft of the member's deposit account with an advance.

Seven commenters (five FHLBanks, one advisory council and one trade association) supported this provision. One FHLBank noted that the elimination of the stock purchase requirement contained in the current policy would improve the FHLBank's leverage position and make the program more attractive to shareholders. Four commenters (one FHLBank and three trade associations) believed LOCs, like advances, should be subjected to a stock purchase requirement. One FHLBank noted that this minimizes risk to the FHLBank if the LOC must be drawn upon. One of the trade associations stated that the proposal could exacerbate the risks to which the FHLBanks would be exposed by permitting them to deduct LOCs from their capital calculation and from their reported balances of outstanding advances, permitting a dangerous leveraging of FHLBank balance sheets which would be undetectable to the Finance Board and outside analysts. The other two trade associations stated that unlike commercial banks or other private financial service providers, the FHLBanks operate without an adequate cushion of permanent stock. Most members are free to redeem their stock and give up their membership, and in times of financial difficulty, the Finance Board is unlikely to be able to prevent these members from fleeing the FHLBank System. Further, they believed that the FHLBanks would issue or confirm a much higher volume of LOCs if they are free from requirements to reserve capital to protect taxpayers from the consequences of any mistakes.

The Finance Board's decision not to require that LOCs be included in a member's advances-to-capital stock ratio calculation will not undermine the safety and soundness of the FHLBank System. Under the capital requirements of the FHLBanks specified in the Bank Act, members must purchase capital in their FHLBank equal to the greater of 1 percent of their residential mortgage assets, 0.3 percent of total assets, or 5 percent of their outstanding advance balances. See 12 U.S.C. 1426. These statutory capital requirements, together with the Finance Board's regulation limiting the FHLBank System's debt to 20 times capital, assure that the FHLBanks have capital-to-asset ratios which approximates the 5 percent ratio for well-capitalized depository

institutions and is about twice the 2.5 percent capital-to-asset requirements for Fannie Mae and Freddie Mac.

On a risk-adjusted basis, the FHLBanks are even better capitalized than the raw numbers would indicate. To be considered well-capitalized, depository institutions must have total risk-based capital of 10 percent and, as of year-end 1997, insured depository institutions held 12.65 percent risk-based capital on average. By comparison, the FHLBanks held over 22 percent risk-based capital at year-end 1997. As of year-end 1997, advances outstanding to members totaled \$202.2 billion and LOCs outstanding totaled \$2.9 billion. Even if, as a result of the changes in policy implemented by this final rule, the total amount of LOCs outstanding increased, FHLBanks would remain well-capitalized.

Because a LOC must be fully collateralized at time of issuance, a FHLBank would have secured sufficient collateral to reimburse the FHLBank for any draw, minimizing the financial risk to the FHLBank. In fact, unlike commercial financial institutions, the FHLBanks generally have required members to secure LOCs with collateral in excess of the value of the LOC. Because the regulation clarifies that the contingent liability of an LOC is covered by section 10(c) of the Bank Act that provides a FHLBank shall have a lien upon the stock of a member as further collateral security for all indebtedness of the member to the FHLBank, the FHLBank's position would be further secured. In addition, § 938.5(a)(1)(ii) provides that a member or nonmember requesting an LOC is subject to the same underwriting criteria that applies to the making of advances. It is anticipated that FHLBanks will use this information to minimize their exposure to credit risk. Therefore, eliminating the requirement that LOCs be supported by the purchase of capital stock does not present any safety and soundness concerns.

4. Priority Lien on Member Collateral

The cross-reference to § 935.10 that has been added to § 938.5(b) is intended to make clear that the statutory priority lien that applies to any security interest granted by a member, or an affiliate of a member, to a FHLBank, see 12 U.S.C. 1430(f), applies to security interests in collateral pledged to secure standby LOCs.

IV. Regulatory Flexibility Act

The final rule applies only to the FHLBanks, which do not come within the meaning of "small business," as defined in the Regulatory Flexibility Act (RFA). See 5 U.S.C. 601(6). Therefore, in

accordance with section 605(b) of the RFA, 5 U.S.C. 605(b), the Finance Board hereby certifies that this final rule will not have a significant economic impact on a substantial number of small entities.

List of Subjects

12 CFR Part 938

Federal home loan banks, Credit, Letters of credit, Community development and housing.

12 CFR Part 943

Federal home loan banks, Checks, Price controls, Reporting and recordkeeping requirements.

Accordingly, the Finance Board hereby amends chapter IX, title 12, Code of Federal Regulations, as follows:

1. Add part 938 to read as follows:

PART 938—STANDBY LETTERS OF CREDIT

Sec.

938.1 Definitions.

938.2 Standby letters of credit on behalf of members.

938.3 Standby letters of credit on behalf of nonmember mortgagees.

938.4 Obligation to Bank under all standby letters of credit.

938.5 Additional provisions applying to all standby letters of credit.

Authority: 12 U.S.C. 1422b, 1429, 1430, 1430b, 1431.

§ 938.1 Definitions.

As used in this part:

Act means the Federal Home Loan Bank Act, as amended (12 U.S.C. 1421–49).

Applicant means a person or entity at whose request or for whose account a standby letter of credit is issued.

Bank means a Federal Home Loan Bank established under the authority of the Act.

Beneficiary means a person or entity who, under the terms of a standby letter of credit, is entitled to have its complying presentation honored.

Community Lending has the meaning set forth in § 970.4 of this chapter.

Confirm means to undertake, at the request or with the consent of the issuer, to honor a presentation under a standby letter of credit issued by a member or nonmember mortgagee.

Document means a draft or other demand, document of title, investment security, certificate, invoice, or other record, statement, or representation of fact, law, right, or opinion that is presented under the terms of a standby letter of credit.

Finance Board means the agency established by the Act as the Federal Housing Finance Board.

Issuer means a person or entity that issues a standby letter of credit.

Member means an institution that has been approved for membership in a Bank and has purchased capital stock in the Bank in accordance with §§ 933.20 and 933.24 of this chapter.

Nonmember mortgagee means an entity certified as a nonmember mortgagee pursuant to § 935.22(b) of this chapter.

Nonmember SHFA means a nonmember mortgagee that is a "state housing finance agency," as that term is defined in § 935.1 of this chapter, and that has met the requirements of § 935.22(d) of this chapter.

Presentation means delivery of a document to an issuer, or an entity that has undertaken a confirmation at the request or with the consent of the issuer, for the giving of value under a standby letter of credit.

Residential housing finance means:

(1) The purchase or funding of "residential housing finance assets," as that term is defined in § 935.1 of this chapter; or

(2) Other activities that support the development or construction of residential housing.

Small business means a "small business concern," as that term is defined by section 3(a) of the Small Business Act (15 U.S.C. 632(a)) and implemented by the Small Business Administration at 13 CFR part 121, or any successor provisions.

Standby letter of credit means a definite undertaking by an issuer on behalf of an applicant that represents an obligation to the beneficiary, pursuant to a complying presentation: to repay money borrowed by, advanced to, or for the account of the applicant; to make payment on account of any indebtedness undertaken by the applicant; or to make payment on account of any default by the applicant in the performance of an obligation. The term *standby letter of credit* does not include a commercial letter of credit, or any short-term self-liquidating instrument used to finance the movement of goods.

§ 938.2 Standby letters of credit on behalf of members.

(a) *Authority and purposes.* Each Bank is authorized to issue or confirm on behalf of members standby letters of credit that comply with the requirements of this part, for any of the following purposes:

(1) To assist members in facilitating residential housing finance;

(2) To assist members in facilitating community lending that is eligible for

any of the Banks' CICA programs under part 970 of this chapter;

(3) To assist members with asset/liability management; or

(4) To provide members with liquidity or other funding.

(b) *Fully secured.* A Bank, at the time it issues or confirms a standby letter of credit on behalf of a member, shall obtain and maintain a security interest in collateral that is sufficient to secure fully the member's unconditional obligation described in § 938.4(a)(2) of this part, and that complies with the requirements set forth in paragraph (c) of this section.

(c) *Eligible collateral.* (1) Any standby letter of credit issued or confirmed on behalf of a member may be secured by collateral that is eligible to secure advances under § 935.9(a) of this chapter. Only standby letters of credit issued for the purposes described in paragraphs (a)(3) or (a)(4) of this section shall be counted in making the calculation required under § 935.9(a)(4)(iii).

(2) A standby letter of credit issued or confirmed on behalf of a member for a purpose described in paragraph (a)(1) or (a)(2) of this section may, in addition to the collateral described in paragraph (c)(1) of this section, be secured by:

(i) Secured or federally-guaranteed loans to small businesses or securities representing interests in such loans; or

(ii) Obligations of state or local government units or agencies, rated as investment grade by a nationally-recognized rating agency.

§ 938.3 Standby letters of credit on behalf of nonmember mortgagees.

(a) *Nonmember mortgagees.* Each Bank is authorized to issue or confirm on behalf of nonmember mortgagees standby letters of credit that are fully secured by collateral described in §§ 935.24(b)(1)(i) or (ii) of this chapter, and that otherwise comply with the requirements of this part, for any of the following purposes:

(1) To assist nonmember mortgagees in facilitating residential housing finance;

(2) To assist nonmember mortgagees in facilitating community lending that is eligible for any of the Banks' CICA programs under part 970 of this chapter;

(3) To assist nonmember mortgagees with asset/liability management; or

(4) To provide nonmember mortgagees with liquidity or other funding.

(b) *Nonmember SHFAs.* Each Bank is authorized to issue or confirm on behalf of nonmember SHFAs standby letters of credit that are fully secured by collateral described in § 935.24(b)(2)(i)(A), (B) or

(C) of this chapter, and that otherwise comply with the requirements of this part, for the purpose of facilitating residential or commercial mortgage lending that benefits individuals or families meeting the income requirements in section 142(d) or 143(f) of the Internal Revenue Code (26 U.S.C. 142(d) or 143(f)).

§ 938.4 Obligation to Bank under all standby letters of credit.

(a) *Obligation to reimburse.* A Bank may issue or confirm a standby letter of credit only on behalf of a member or nonmember mortgagee that has:

(1) Established with the Bank a cash account pursuant to §§ 934.5, 935.24(b)(2)(i)(B) or 935.24(d) of this chapter; and

(2) Assumed an unconditional obligation to reimburse the Bank for value given by the Bank to the beneficiary under the terms of the standby letter of credit by depositing immediately available funds into the account described in paragraph (a)(1) of this section not later than the date of the Bank's payment of funds to the beneficiary.

(b) *Prompt action to recover funds.* If a member or nonmember mortgagee fails to fulfill the obligation described in paragraph (a)(2) of this section, the Bank shall take action promptly to recover the funds that such member or nonmember mortgagee is obligated to repay.

(c) *Obligation financed by advance.* Notwithstanding the obligations and duties of the Bank and its member or nonmember mortgagee under paragraphs (a) and (b) of this section, the Bank may, at its discretion, permit such member or nonmember mortgagee to finance repayment of the obligation described in paragraph (a)(2) of this section by receiving an advance that complies with sections 10 or 10b of the Act and part 935 of this chapter.

§ 938.5 Additional provisions applying to all standby letters of credit.

(a) *Written policy; other requirements.* Each standby letter of credit issued or confirmed by a Bank shall:

(1) Be issued or confirmed only in compliance with a written policy, developed and implemented by the Bank to govern its standby letter of credit programs, that:

(i) Is consistent with the provisions of the Act and this part;

(ii) Sets forth credit underwriting criteria, consistent with the provisions of § 935.5 of this chapter, to be applied in evaluating applications for standby letters of credit and renewals thereof;

(iii) Sets forth criteria regarding the pricing of standby letters of credit,

including any special pricing provisions for letters of credit that facilitate the financing of projects that are eligible for any of the Banks' CICA programs under part 970 of this chapter; and

(iv) Provides that, for any draw made by a beneficiary under a standby letter of credit, the applicant will be charged a processing fee calculated in accordance with the requirements of § 943.6(b) of this chapter;

(2) Contain a specific expiration date, or be for a specific term; and

(3) Require approval in advance by the Bank of any transfer of the standby letter of credit from the original beneficiary to another person or entity;

(b) *Additional collateral provisions.* (1) A Bank may take such steps as it deems necessary to protect its secured position on standby letters of credit, including requiring additional collateral, whether or not such additional collateral conforms to the requirements of §§ 938.2 or 938.3 of this part.

(2) Collateral pledged by a member or nonmember mortgagee to secure a letter of credit issued or confirmed on its behalf by a Bank shall be subject to the provisions of §§ 935.9(b), 935.9(d), 935.9(e), 935.10, 935.11 and 935.12 of this chapter.

PART 943—COLLECTION, SETTLEMENT, AND PROCESSING OF PAYMENT INSTRUMENTS

2. The authority citation for part 943 continues to read as follows:

Authority: 12 U.S.C. 1430, 1431.

3. Amend § 943.6 by revising paragraph (c) to read as follows:

§ 943.6 Pricing of services.

* * * * *

(c) *Review and publication.* The Finance Board shall from time to time and at least annually review the cost of capital adjustment factor and review prices for services authorized in this part for compliance with the principles set forth in paragraphs (a) and (b) of this section. All prices for Bank services authorized in this part will be published annually in the **Federal Register**, except those for fees charged to an applicant for draws made by a beneficiary under a standby letter of credit.

Dated: October 28, 1998.

By the Board of Directors of the Federal Housing Finance Board.

Bruce A. Morrison,
Chairman.

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