Federal Housing Finance Board

Memorandum

May 3, 1991

TO: J. Stephen Britt
Executive Director

FROM: Beth L. Climo
General Counsel

SUBJECT: Standby Letters of Credit

Issues:

We have been requested to provide an opinion on the parameters of the Federal Home Loan Banks' ("Banks'") standby letters of credit authority. Specifically, we have been asked to review the following issues: (1) the authority of the Banks to issue standby letters of credit; (2) whether the Banks are authorized to issue unsecured standby letters of credit; and (3) whether the Banks may issue standby letters of credit on behalf of nonmembers.

Conclusions:

We have reviewed these issues and arrived at the following conclusions:

(1) The Banks have the general authority to issue and confirm standby letters of credit. Such authority has been derived from the Banks' lending authority. However, section 11(e)(2)(A) of the Bank Act may provide an alternative basis for authorizing the Banks to issue standby letters of credit;

(2) while there is a legal theory under which the Banks would rely solely on their check processing and payment authority under section 11(e)(2)(A) of the Bank Act to issue unsecured standby letters of credit, the better analysis -- based on their lending authority -- is that the Banks are required to fully collateralize a11 standby letters of credit; and

(3) While a legal theory exists under the Banks' check processing and payment authority that would allow the Banks to issue standby letters of credit on behalf of nonmembers, the better analysis - based on their lending authority -- is that the Banks may not issue standby letters of credit on behalf of nonmembers.

The opinion also includes a brief discussion of the treatment of standby letters of credit under the advances/capital stock ratio. Two appendices are included as well. The first provides background on the different types of letters of credit and distinguishes among them. The second provides a summary of the existing policy guidelines that govern letters of credit.

I) THE BANKS MAY ISSUE STANDBY LETTERS OF CREDIT

Since 1983, the Banks have been issuing standby letters of credit [1] on behalf of members under their lending authority. The authority to issue standby letters of credit was first recognized in a 1983 opinion by Thomas P. Vartanian, former General Counsel of the Federal Home Loan Bank Board ("FHLBB"). He opined that:

> ... a FHLBank's issuance of a standby letter of credit, which is the functional equivalent of a loan between the Issuer and the Account Party in commercial law, involves an extension of credit by a FHLBank to the member requesting the credit that is permissible under the FHLBank lending authority set forth in section 10 of the Bank Act. [2]

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1. As defined by the Federal Deposit Insurance Corporation's regulation, a standby letter of credit represents an obligation to a beneficiary on the part of a Bank:.

   (1) to repay money borrowed by or advanced to or for the account of an account party;

   (2) to make payment on account of any indebtedness undertaken by an account party; or

   (3) to make payment on account of any default by an account party in the performance of an obligation.

   12 C.F.R. § 337.2 (1982).

2. Thomas P. Vartanian, FHLBanks Letters of Credit Programs, Office of General Counsel Slip Opinion, May 21, 1983 (hereafter referred to as "Vartanian").

In addition, Mr. Vartanian stated that additional authority for the issuance of standby letters of credit could be found in the Banks' incidental powers. In other words, letters of credit were determined to be an "incidental and adjunctive" aspect of the Bank's lending authority.

In short, standby letters of credit are considered the functional equivalent of advances and are an incidental activity to the Banks' advances authority. Thus, the parameters of the Banks' authority to issue standby letters of credit may be only as broad as their advances authority.

II) WHETHER THE BANKS HAVE THE AUTHORITY TO ISSUE UNSECURED STANDBY LETTERS OF CREDIT

A) Based on the Banks' lending authority, the Banks may not issue unsecured standby letters of credit

As discussed above, the Banks' derive their authority to issue standby letters of credit from their lending authority. Generally, the Banks' authority to make advances is found in section 10(a) of the Bank Act, as amended by Section 714(a) of Financial Institutions Reform, Recovery and Enforcement Act, of 1989 [3] ("FIRREA"). [4] Section 10(a) requires that all advances be made only to members and be fully secured by specifically identified assets.[5]

In addition to section 10 advances, the Banks are authorized to make advances under section 11(g) of the Bank Act. For example, under section 11(g)(3), each Bank may make advances to members, with a maturity not exceeding five years, upon such terms and conditions as the Federal Housing Finance Board ("Finance Board*) prescribes.[6] In addition, each Bank is authorized under section 11(g)(4) to make:

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3. Rub. L. No. 101-73, 103 Stat. 183 (August 9, 1989).

4. 12 U.S.C.A. § 1430(a) (West Supp. 1990).

5. Eligible collateral for advances include inter alia residential mortgage loans, government securities, mortgage-backed securities issued or insured by Federal government agencies, deposits of a Bank, and other real estate-related collateral acceptable to the Bank. See 12 U.S.C.A. § 1430(a)(1-4) (West Supp. 1990).

6. 12 U.S.C.A. § 1431(g)(3) (West Supp. 1990).

> ... advances with a maturity of not to exceed five years which are made to members whose creditor liabilities (not including advances from the [Bank]) do not exceed 5 per centum of their net assets, and which may be made without security of home mortgages or other security, upon such terms and conditions as the [Finance Board] may prescribe.[7] (Emphasis added.)

Although section 11(g)(4), by its terms, states that such advances may be made "without security of home mortgages or other security," a cross reference in section 10(a) appears to require that such advances be fully secured. Section 10(a), as amended by section 714 of FIRREA, provides in pertinent part:

> Each Federal Home Loan Bank is authorized to make secured advances to its members upon collateral sufficient, in the judgment of the Bank, to fully secure advances obtained from the Bank under this section or section 1431(g) of this title.[8]

Thus, as amended by FIRREA, section 10(a) conflicts with section 11(g)(4) and would seem to require that all advances issued by a Bank -- whether pursuant to section 10 or section 11(g) -- be fully collateralized by assets that qualify under the enumerated categories in section 10(a).

Sections 10(a) and 11(g)(4) appear to be in direct conflict. Ordinarily, if two sections are in conflict the later legislative enactment controls. A rule of statutory construction supports this proposition: "Statutes for the same subject, although in apparent conflict, are construed to be in harmony if reasonably possible. If there is an irreconcilable conflict between the new provision and the prior statutes, the new provision will control as it is the later expression of the legislature." Sutherland, Statutes and Statutory Construction § 51.02 (4th ed. 1984).

Section 10(a), the latter expression of Congress, requires all advances to be fully secured, including section 11(g)(4) advances. Thus, standby letters of credit issued under both sections 10(a) and 11(g) are required to be fully secured by assets that meet the above enumerated types of eligible collateral.

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7. 12 U.S.C.A. § 1431(g)(4) (West Supp. 1990).

8. 12 U.S.C.A. § 1430(a) (West Supp. 1990).

B) The authority to issue unsecured standby letters of credit may be incidental and adjunctive to Banks' check payment and processing authority

As an alternative to reliance upon the Banks' lending authority as the source for the Banks' standby letter of credit authority, Mr. Vartanian in his 1983 opinion noted that the authority to issue letters of credit also may be found as an "adjunctive and incidental aspect" of the Banks' check payment and instrument processing authority in section II(e)(2)(A) of the Bank Act.[9] He concluded that a standby letter of credit could involve a Bank paying drafts presented by a third party Beneficiary upon a member's default or guaranteeing a member's money obligation "as long as the disbursement process under the credit is directly linked to a Bank (demand deposit) account of the member at whose request the credit was issued." He reasoned that:

> ... while it may be argued that this statutory limitation on the FHLBanks' payment instrument services also precludes a FHLBank from paying a draft of a third party presented under the terms of a standby letter of credit, it is my view that the authority set forth in section 11(e)(2)(A) would permit the FHLBanks to enter into an obligation with a third party to honor a payment instrument drawn on or issued by its member.[10]

Thus, relying solely on section 11(e)(2)(A), the Banks may have a legal basis for issuing unsecured standby letters of credit. Non-credit services provided under section 11(e)(2)(A) do

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9. Section 11(e)(2)(A) of the Bank Act provides in pertinent part:

> The Board may ... authorize Federal Home Loan Banks to be drawers of, and to engage in, or be agents or intermediaries for, or otherwise participate or assist in, the collection and settlement of (including presentment, clearing, and payment of, and remitting for), checks, drafts, or any other negotiable or nonnegotiable items or instruments of payment drawn on or issued by members of any Federal Home Loan Bank or by institutions which are eligible to make application to become members pursuant to section 1424 of this title, and to have such incidental powers as the Board shall find necessary for the exercise of any such authorization.

12 U.S.C.A. § 1431(e)(2)(A) (West Supp. 1990).

10. Id. at 10.

not require collateral security. In practical operation, the Banks probably would have to require the Account Party/member to always maintain enough deposits to cover any request for payment by a Beneficiary, because any overdraft protection could be considered an extension of credit by the Bank which is required to be collateralized under section 10(a).[11] However, the very purpose of a letter of credit is to give the Beneficiary direct recourse to someone other than the Account Party and to obligate the Issuer/Bank to make a payment directly to the Beneficiary. This purpose is somewhat defeated if the Account Party is required to maintain deposits sufficient to cover any Beneficiary request for payment. Thus, relying solely on the Banks' check processing and payment authority may not be a feasible alternative.

III) WHETHER THE BANKS HAVE THE AUTHORITY TO ISSUE STANDBY LETTERS OF CREDIT ON BEHALF OF NONMEMBERS

A) Based on the Banks' lending authority, the Banks may not issue standby letters of credit on behalf of nonmembers

The Banks would seem to lack the authority to issue standby letters of credit on the part of nonmembers when such activity is viewed in light of the Banks' express or incidental lending authority.[12] Sections 10 and 11(g) of the Bank Act clearly limit the Banks' advances programs to members.[13]

However, standby letter of credit confirmations may be a viable alternative to directly issuing a standby letter of credit on behalf of a nonmember. In a letter of credit confirmation, an Issuer/member issues a standby letter of credit on behalf of an Account Party to a Beneficiary. In turn, the Bank confirms its

11. The Finance Board has not issued final advances regulations. The definition of an advance is still being reviewed. If the Finance Board's advances regulations were to include overdraft protection within the term "advances," this would hinder this legal avenue for Bank issuance of unsecured letters of credit. However, if the advances regulations were to exclude overdraft protection from the definition of an advance, the legal avenue under section 11(e)(2)(A) of the Bank Act for Bank issuance of unsecured standby letters of credit would be more viable.

12. We will be analyzing section 10b of the Bank Act which appears to authorize the Banks to make advances to "nonmember mortgagees. " If we find section 10b to be an available authority to make certain types of advances to nonmembers, arguably that same authority, could be used to issue standby letters of credit, subject to the' same parameters as would apply to advances under that section.

13. 12 U.S.C.A. §§ 10, 11(g) (West Supp. 1990),

member's standby letter of credit and thereby undertakes to pay the Beneficiary of a member's standby letter of credit in the event the member defaults on its standby letter of credit obligation. The confirmation offers credit enhancement to the member's letter of credit. However, because the authority to confirm letters of credit also is derived from the Banks' lending authority, the member is required to offer collateral to secure the Bank's confirmation of the letter of credit.

B) The authority to issue standby letters of credit on behalf of nonmembers may be incidental and adjunctive to Banks' check payment and processing authority

AS mentioned above, the Banks are prohibited from making advances to nonmembers. An argument can be made, however, for the authority to issue standby letters of credit on behalf of nonmembers through reliance on the section 11(e)(2)(A) check processing and payment authority, rather than on section 10 or 11(g) lending authorities.

Under this theory, if the Banks are to offer standby letters of credit to nonmembers, they must be able to take deposits from nonmembers. An argument can be made that such authority exists under section 11(e)(2) (A), as amended by the Depository Institutions Deregulation and Monetary Control Act of 1980.[14] Section 11(e)(2)(A) authorizes the Banks to be "drawees of ... checks, drafts, of any negotiable or non-negotiable items or instruments drawn on or issued by members or by institutions eligible to make application to become members.' (Emphasis added.)

In order to be a drawee of a check, a Bank must take deposits from the person drawing on the Bank, Thus, in addition to members, institutions "eligible to make application" for membership are arguably authorized to use the Banks as depositories of funds. The "eligible to make application" language was not significant until FIRREA expanded the list of institutions eligible for membership to include commercial banks and credit unions. Thus, the Banks would now system to have the authority to accept deposits from nonmembers that are eligible to make application for membership.[15]

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14. Pub. L. N O. 96-221, 94 Stat. 132 (March 31, 1980).

15. We are in the process of determining whether the phrase "eligible to make application for membership" requires that the nonmember meet all the eligibility requirements for membership, including the 10% residential mortgage loan test, of whether it requires a nonmember to only be an insured depository institution as required by section 4(a)(l) of the Bank Act.

Furthermore, section 11(e)(2)(A) authorizes the Banks to offer check clearing and collection services to institutions eligible to make application and grants the Banks the incidental authority necessary to exercise such authority. Arguably, it is necessary to have an institution maintain deposits with a Bank in order for the Bank to effectively handle that institution's check processing needs. Thus, the Banks' authority to accept deposits from nonmember institutions eligible to make application is arguably "incidental and adjunctive" to the authority to offer check processing services to such institutions.

Whether the Banks' authority to accept deposits from nonmembers is viewed as an express authority to be drawees of checks issued by institutions eligible to make application or as an activity incidental to the power to offer check clearing and collection services, section 11(e)(2)(A) arguably provides legal support for the Banks to accept deposits from nonmembers that are eligible to make application.

Under the above argument, a Bank would then issue a standby letter of credit on behalf of a nonmember to a Beneficiary. Upon the Account Party/nonmember's default, the Bank would have to honor a draft presented by a Beneficiary on the nonmember's demand deposit account at the Bank.

While the above analysis may present a possible avenue for the issuance of standby letters of credit on behalf of nonmembers, it contains a number of flaws. In practical operation, the Banks probably would have to require the nonmember to always maintain enough deposits to cover any request for payment by a Beneficiary, because any overdraft protections could be considered a prohibited extension of credit by the Bank to a nonmember. However, the very purpose of a letter of credit is to give the Beneficiary direct recourse to someone other than the Account Party and to obligate the Issuer/Bank to make a payment directly to the Beneficiary? Thus, relying solely on the Banks' check processing and payment authority may not be feasible.

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16. As mentioned in Note 11, the Finance Board has yet to address the issue of whether overdraft protection is included within the term "advance." If the Finance Board's proposed advances regulations were to include overdraft protection as an advance, the Banks may not be able to accept deposits from nonmembers. Alternatively, if overdraft protection is not considered an advance, the Banks may be able to accept deposits from nonmembers and offer standby letters of credit as incidental to such authority.

Although the Bank Act provides a possible argument for authorizing the Banks to accept deposits from and offer their ancillary services to nonmembers, as a practical matter it may be politically unfeasible. The Office of the General Counsel of the Board of Governors of the Federal Reserve System has informed us that private sector providers of correspondent services may challenge the Banks' authority to provide ancillary services to nonmembers, including the acceptance of deposits.

IV) TREATMENT OF STANDBY LETTERS OF CREDIT UNDER THE ADVANCES/CAPITAL STOCK RATIO

Advances made pursuant to section 10(a) must be included in the calculation of a member's advances/capital stock ratio. Section 10(c) requires Banks to hold members' Bank stock as further collateral for all advances made pursuant to section 10 and requires a five percent advances/capital stock ratio. Thus, advances and standby letters of credit made pursuant to section 10 are included in the calculation of the member's five percent advances/capital stock ratio.

The five percent advances/capital stock ratio limitation is not referred to in section 11(g). Thus advances made pursuant to sections 11(g)(3) and 11(g)(4) would seem not to be subject to the five percent advances/capital stock ratio limitations. This interpretation of section 11(g) is consistent with the policy of the Office of General Counsel of the former FHLBB.[17]

17. Arthur W. Leibold, Sr., Office of General Counsel, letter to Richard J. Rowe, Assistant Director of Bank Operations, April 13, 1971. The FHLBB's policy was as follows:

> [T]he capital stock requirement with respect to the limitation on advances is set forth in § 10 of the Bank Act, and is not repeated or referred to in § 11. It has been the position of this Office that the capital stock requirement contained in § 10 does not apply to advances under § 11.
>
> While the capital stock requirement could be applied to § 11 advances as a matter of administrative policy, it has been our opinion, as noted immediately above, that the statutory requirement is applicable only to § 10.

In sum, advances made pursuant to sections 11(g)(3) and 11(g)(4) seem not to be subject to section 10(c)'s five percent advance/capital stock ratio limitation. Thus, standby letters of credit made pursuant to sections 11(g)(3) and 11(g)(4), which are functional equivalents of advances, also would appear to be excluded from the calculation of a member's five percent advances/capital stock ratio.

Beth L. Climo
General Counsel

APPENDIX #1

I) TYPES OF LETTERS OF CREDIT

A letter of credit is an agreement by a financial institution made at the request of a customer that the financial institution will honor drafts or other demands for payment from a third party that comply with the specific conditions in the letter of credit.[1] A letter of credit transaction involves three parties: the party applying for the letter of credit ("Account Party"--in this case the member), the party who agrees to provide the letter of credit ("Issuer"--in this case the Bank), and the third party who is entitled to draw or demand payment under the letter of credit ("Beneficiary").[2] The letter of credit constitutes a primary obligation of the Issuer to honor any drafts or documents presented by the Beneficiary as long as they comply with the terms of the letter of credit?

Generally, there are two types of letters of credit--commercial and standby. Commercial letters of credit are issued to support trade transactions and usually involve the payment of money under a contract of sale. They are designed to be payment vehicles in which drawings are anticipated and are triggered by the Beneficiary's performance under the sales agreement.[3]

In contrast, standby letters of credit usually involve an obligation of the Issuer to make payment upon the default by the

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1. U.C.C. § 5-103(l)(a) (1989).

2. See U.C.C. § 5-103(1)(c), (d) and (g) (1989).

3. See J. White & R. Summers, Handbook of the Law Under Uniform Commercial Code, § 18-7 at 743 (2d. Ed. 1980).

4. See May 25, 1988 Federal Home Loan Bank Board letter from Thomas Sheehan to Carol A. Jackson.

Account Party in the performance of an obligation.' Standby letters of credit are issued to back performance and are designed to be unutilized secondary supports. Drawings on the letter of credit are precipitated by an Account Party's default.'

A traditional standby letter of credit transaction is distinguishable from a standby letter of credit confirmation, in that the latter is generally a four party transaction. In the context of the Federal Home Loan Bank System, a letter of credit confirmation would operate as follows: an Issuer/member issues a letter of credit on the part of an Account Party to a Beneficiary; In turn, the Issuer/member requests its Bank to confirm its letter of credit. By confirming a member's standby letter of credit, a Bank undertakes to pay the Beneficiary of a member's letter of credit in the event the member defaults on its obligation. The confirmation offers credit enhancement to the member's letter of credit.

Direct pay letters of credit are a combination of commercial and standby letters of credit. Direct pay letters of credit are similar to standby letters of credit in that they are issued to back the financial performance of the account party. However, they differ from standby letters of credit in that they are the primary mechanism for satisfying the Account Party's obligation.

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5. Thomas P. Vartanian, in a 1983 Federal Home Loan Bank Board legal opinion differentiated a standby letter of credit from a traditional guaranty as follows:

> Although a standby letter of credit functions in a transaction similar to a guaranty in effect, a standby credit differs from a guaranty in two major respects: (1) the obligation of a guarantor is secondary and ancillary to the underlying contract and therefore carries all the defenses that the principal has against the creditor, whereas the standby obligation is primary, and does not carry the defenses of the Account Party against the Beneficiary; and (2) the guaranty obligation does not mature unless the principal debtor is in default under the facts surrounding the underlying contract, whereas an Issuer's standby obligation arises under presentment of documents or requisite papers in conformance with the terms of the letter of credit.

Vartanian, supra at 2.

6. Sheehan, supra at 1.

APPENDIX #2

SUMMARY OF EXISTING STANDBY LETTER ON CREDIT POLICY GUIDELINES[1]

The existing policy guidelines on standby letters of credit authorize the Banks to issue and confirm[2] standby letters of credit[3] and direct pay letters of credit,[4] on behalf of member

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1. The Guidelines were adopted by the former Federal Home Loan Bank on May 11, 1989.

2. Under the guidelines, the Banks are prohibited from issuing "back-to-back" letters of credit. A typical back-to-back standby letter of credit involves a member issuing a letter of credit to support the obligation of its customer to a third party Beneficiary. Because the member's credit is deemed insufficient by the Beneficiary, a credit enhancement by another party is needed. Therefore, the member calls upon the Bank to issue a letter of credit which authorizes the third party to draw on the Bank if the member defaults under the terms of its letter of credit. The former FHLBB prohibited the Banks from issuing back-to-back letters of credit reasoning that they effectively placed the Banks in a position of supporting the obligations of their members' customers, i.e., nonmembers. Confirmations have been used as a viable alternative to back-to-back letters of credit.

3. The policy guidelines do not authorize the Banks to issue commercial letters of credit. We have been unable to locate any past legal opinions interpreting the Banks* authority to issue commercial letters of credit. Commercial letters of credit support commercial transaction involving the buying and selling of goods. Thus, it is difficult to argue that they are related to or support housing finance However, it is prudent to reserve any judgment on such authority given that more and more commercial banks are joining the Bank System, which are directly involved in commercial letters of credit. Although probably a stretch, the Banks may be interested in confirming members' commercial letters of credit. However, it will be hard to justify such activity as housing related.

4. Although direct pay letters of credit are a combination of commercial and standbys, the Office of District Banks ("ODB") of the former FHLBB classified them as standbys and authorized their use by the Banks, ODB reasoned that the purpose for which a letter of credit is issued, (i.e., support for the member's financial performance), rather than the event that

institutions. The guidelines require that both issuances and confirmations of standby letters of credit be fully collateralized to the same extent as regular advances. Furthermore, the guidelines include issuances and confirmations of standby letters of credit in the advances/capital stock ratios under section 10 of the Bank Act.[3] As discussed in the opinion, there is a legal argument that standby letters of credit issued pursuant to section 11(g) are not subject to the advances/capital stock ratios. However, as a matter of policy the former FHLBB chose to require all Bank standby letters of credit to be included in such calculations.

Under the existing guidelines, the Banks may issue or confirm standby letters of credit or direct pay letters of credit to facilitate the following types of members' business transactions with third parties:

1) purchase of, or commitment to purchase, mortgage loans where the letter of credit functions as a performance bond and is restricted to housing-related purposes;

2) collateralization of public unit deposits;

3) collateralization of Internal Revenue Code Section 936 deposits;

4) interest rate swaps;

5) tax-exempt bonds or notes when the issues are designed to promote housing development.

6) others that encourage or assist the asset/liability management of member institutions; and

7) other transactions that promote home financing or housing activity.

Purchase of, or commitment to purchase, mortgage loans

Members frequently engage in business arrangements whereby business entities advance funds to a member for the origination and delivery of mortgages or make commitments to purchase mortgage loans from the member's portfolio. Third parties such as the Residential funding Corporation ("RFC") generally require standby

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(Footnote 4 continued from previous page)
triggers the draw against it, should determine its classification as a commercial or, a standby letter of credit,

5. 12 U.S.C.A. § 1430 (West Supp. 1990).

letters of Credit to ensure the delivery of mortgage loans conforming to the agreement with the attendant documentation. For example, when a member defaults on its promise to provide full documentation in the prescribed time period or to repurchase an undocumented mortgage loan, the RFC or its designee will exercise its right to draw on the letter of credit for the repurchase price of the mortgage loan.

As a result of these mortgage-related transactions, members generally have more funds available for reinvestment in mortgages. Accordingly, because the Banks were established by Congress to promote the flow of mortgage funds, the issuance of standby letters of credit to facilitate these transactions would be in accord with the Banks' credit mission.

Collateralization of Public Unit Deposits

Public units generally have limited investment authority for the placement of their deposits and require security for their deposits or a letter of credit from an acceptable bank. If these Banks are authorized to issue standby letters of credit to collateralize these deposits, members in those states that authorize placement of public unit deposits in thrifts may be able to effectively compete for these deposits. A letter of credit from a Bank would ensure prompt repayment. Members may prefer to utilize Bank standby letters of credit because the Banks have less onerous procedures for collateralization that other lenders and accept mortgage loans as collateral.

Collateralization of Internal Revenue Code Section 936 Deposits

Section 936 of the Internal Revenue Code accords special tax treatment to earnings Of Corporations operating in Puerto Rico if such earnings are reinvested in prescribed activities within Puerto Rico. Because section 936 deposits carry a lower interest rate relative to other deposits due to the preferred tax treatment and the localized market for these deposits, members with these deposits can reduce substantially their cost of funds. Permitting the New York Bank to issue standby letters of credit (or firm commitments for advances) collateralizing section 936 deposits would enable Puerto Rican members to attract a large volume of section 936 deposits and would promote their financial viability.

Interest-rate swaps

Interest-rate swaps are an exchange of contractual variable-rate interest payments of one party for interest payments with a fixed rate of another party. The participants are exchanging only the cost of interest payments, and any underlying obligations remain unchanged on the balance sheets of the two parties. Interest-rate swaps generally would reduce members' sensitivity to interest-rate changes by effecting a closer match of liabilities to assets with a similar yield, but may involve less risk and cost than hedging with interest-rate futures because these transactions are more

straightforward and simpler to administer than hedge programs.

The agreement underlying the interest-rate swap transaction may require collateral or a standby letter of credit from the party with the lower credit standing. The standby letter of credit essentially guarantees the installment payments of interest from the weaker party until the agreement is terminated, Accordingly, because these exchanges of contractual interest obligations may occur with domestic and foreign corporations that are unfamiliar with the thrift industry, such corporations would require members to obtain standby letters of credit from a widely recognized bank. Authorizing Bank standby letters of credit for this purpose encourages more members to engage in interest-rate swaps and, thus, would advance the Finance Board's goal of promoting interest-rate stability for thrift institutions,

Collateralize tax-exempt bonds or notes

Frequently, members have the opportunity to be the lender for the construction of housing projects. The funding for the loans sometimes comes from the proceeds of bonds issued by a State Housing Finance Authority, For the funding to be economically viable, a credit enhancement sufficient to bring the bond rating to AA is required. Bank standby letters of credit and confirmations are used to enhance the credit rating of the bonds.

The state Housing Finance Commission usually must approve a Bank member as a lender for the project. Once the Bank member is approved, the local authority issues the tax-exempt mortgage revenue bonds for the construction of the housing project. A bond trustee acting on the part of the bondholders lends (not a deposit) the bond- proceeds to a Bank member, which invests in new mortgage loans. The Bank issues or confirms a standby letter of credit in favor of the trustee for the benefit of the bondholders, to secure repayment of the loan to the Bank member. This letter of credit enables a higher rating for the bonds. (See Policy Guidelines for limitations on tax-exempt bonds)