

such advances at rates below the price of advances of similar amounts, maturities, and terms made pursuant to section 10(a) of the Act. (12 U.S.C. 1430(a)).

(2) *Advances to nonmember borrowers.* A Bank shall price advances to nonmember borrowers made under a CICA program established pursuant to this section as provided in § 935.24 of this chapter, and may price such advances at rates below the price of advances of similar amounts, maturities, and terms made pursuant to section 10b of the Act. (12 U.S.C. 1430b).

§ 970.8 Limits on access to CICA program advances.

Any limit established by a Bank upon members' or nonmember borrowers' access to CICA advances shall not discriminate in favor of or against any member.

§ 970.9 Reporting.

(a) *CICA policies.* Each Bank shall submit to the Finance Board annually a copy of the policies governing the Bank's CICA programs.

(b) *Quarterly reports.* Each Bank shall report quarterly to the Finance Board on the Bank's use of CICAs.

Dated: April 22, 1998.

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

Bruce A. Morrison,
Chairman.

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FEDERAL HOUSING FINANCE BOARD

12 CFR Part 938

[No. 98-17]

RIN 3069-AA61

Federal Home Loan Bank Standby Letters of Credit

AGENCY: Federal Housing Finance Board.

ACTION: Proposed Rule.

SUMMARY: The Federal Housing Finance Board is proposing to codify its existing policies on Federal Home Loan Bank (FHLBank) standby letters of credit into the form of a regulation and to amend these policies to allow for broader use of these products by FHLBank members and eligible nonmember mortgagees. The proposed rule also would eliminate some of the restrictions currently imposed on issuance of standby letters of credit by FHLBanks that limit the usefulness of these products to members and eligible nonmember mortgagees.

DATES: Comments are due on or before August 6, 1998.

ADDRESSES: Mail comments to Elaine L. Baker, Executive Secretary, Federal Housing Finance Board, 1777 F Street, N.W., Washington D.C. 20006. Comments will be available for inspection at this address.

FOR FURTHER INFORMATION CONTACT: Diane E. Doriis, 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, N.W., Washington, D.C. 20006.

SUPPLEMENTARY INFORMATION:

I. Background

The FHLBanks have been permitted to engage in standby letter of credit (LOC) transactions since 1983, when the predecessor agency to the Federal Housing Finance Board (Finance Board), the former Federal Home Loan Bank Board (FHLBB), first adopted its Policy Guidelines for Issuance of FHLBank Standby Letters of Credit (FHLBB Guidelines). Underlying this policy was a 1983 FHLBB legal opinion which concluded that FHLBank issuance of standby LOCs on behalf of members is permissible under the FHLBanks' authority to make secured advances, set forth in section 10 of the Bank Act, 12 U.S.C. 1430, because a FHLBank standby LOC is the functional equivalent of an advance in that it involves an extension of credit by the FHLBank to its member. Because the FHLBB considered the authority to issue standby LOCs to derive from the authority to make secured advances, the 1983 FHLBB Guidelines, and the 1985 and 1989 revisions thereto, applied the statutory and regulatory requirements pertaining to advances to standby LOC transactions. The substance of the FHLBB Guidelines was maintained when the Finance Board (created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 412 (1989), to succeed the FHLBB as regulator of the FHLBanks) adopted its first standby LOC policy in 1991.

FHLBank participation in standby LOC transactions currently is governed by the Finance Board's Interim Policy Guidelines for FHLBank Standby Letters of Credit (Interim Guidelines), which were adopted in 1993. The Interim Guidelines permit FHLBanks to issue or confirm standby LOCs on behalf of members to facilitate: the purchase of, or commitment to purchase mortgage loans; the collateralization of public unit deposits; the collateralization of

Internal Revenue Code (IRC) Section 936 deposits (deposits made in Puerto Rican financial institutions by corporations operating in Puerto Rico); interest rate swaps and other transactions that assist a member's asset/liability management; transactions that promote home financing, housing activity, or members' involvement in commercial and economic development activities that benefit low-and moderate-income families or activities that are located in low-and moderate-income neighborhoods (community development); and tax-exempt bonds or notes designed to promote housing or the financing of community development. In addition, the Interim Guidelines permit FHLBanks to issue LOCs on behalf of nonmember mortgagees eligible to obtain advances under section 10b of the Bank Act, 12 U.S.C. 1430b, for transactions that promote home financing, housing activity, and community development.

Because the Finance Board retained the substance of the FHLBB Guidelines and, by implication, the 1983 FHLBB legal analysis, the Interim Guidelines continued to impose upon LOCs all of the regulatory requirements and restrictions that apply to advances. For example, the Interim Guidelines require that LOCs: be fully secured with collateral eligible to secure advances under § 935.9(a) of the Finance Board's regulations, 12 CFR 935.9(a); be counted in the calculation of a member's FHLBank stock-to-advances ratio; be issued only for housing finance purposes if they have a term to maturity in excess of five years, or are issued on behalf of non-qualified thrift lender (non-QTL) members; and be included in the calculation of the limitation on advances to non-QTL members set forth in § 935.13 of the regulations, *id.* § 935.13, if issued on behalf of non-QTL members. In addition, the Interim Guidelines limit LOCs and confirmations used for purposes other than interest rate swap transactions to terms of ten years or less and prohibit use of LOC confirmations solely to promote a member's LOC program or to increase a member's profitability from this fee-based service.

As part of an ongoing effort to determine both how FHLBank standby LOCs might be made more useful to member institutions and nonmember mortgagees and how to encourage greater use of LOCs in carrying out the housing and community investment mission of the FHLBank System, the Finance Board recently undertook a survey of the FHLBanks to determine the uses of standby LOCs and the needs of the FHLBanks in issuing standby

LOCs. The Finance Board also undertook a review of the legal bases on which the FHLBanks' LOC authority has been, and could be, grounded. As a result of these efforts, the Finance Board has concluded that FHLBank authority to engage in standby LOC transactions is not limited to the provisions addressed in the 1983 FHLBB legal opinion, but also may be considered to be part of, and incidental to, the FHLBanks' deposit-taking and payment processing powers set forth in section 11(e) of the Bank Act. 12 U.S.C. 1431(e). If a FHLBank's involvement in a standby LOC transaction is considered to be part of its payment processing activity, however, FHLBank fees for LOCs may be subject to a private sector adjustment factor under section 11(e)(2) of the Bank Act. 12 U.S.C. 1431(e)(2). The Finance Board specifically requests comment regarding the consequences of this possibility.

The Finance Board also has determined that the authority of a FHLBank to issue a standby LOC may be considered, in the alternative, to be part of the FHLBanks' incidental authority to enter into commitments to make advances. On the basis of this refined analysis, the Finance Board has concluded that, although there may be safety and soundness and other policy reasons for requiring certain restrictions, it is unnecessary as a matter of law to subject FHLBank LOCs to all of the statutory and regulatory restrictions and limitations that apply to advances.

This rulemaking proposes to amend the Interim Guidelines to provide the FHLBanks with greater flexibility to respond to member needs for standby LOCs in a manner that ensures that FHLBanks' use of standby LOCs is consistent with the FHLBank System's housing and community investment mission and to codify these policies as a regulation. Accordingly, these proposed standby LOC regulations permit FHLBank members to request standby LOCs for a broader range of purposes and remove many of the restrictions on FHLBank standby LOC issuance that have limited the usefulness of such LOCs in the past.

The Finance Board requests comments on all aspects of the proposed rule.

II. Analysis of the Proposed Rule

This rulemaking proposes to add to the Finance Board's regulations, 12 CFR chapter IX, a new part 938 to govern FHLBank Standby LOCs. Definitions relevant to the proposed FHLBank Standby LOC regulation are set forth in § 938.1 of the proposed regulation. Because these definitions have been

drafted in order to implement substantive provisions, they are discussed, as necessary, below in the context of their use in the body of the regulation.

Section 938.2 of the proposed regulation governs FHLBank standby LOCs issued or confirmed on behalf of member institutions. Paragraph (a) authorizes FHLBanks to issue standby LOCs on behalf of members, and to confirm standby LOCs issued by members, that conform to the requirements of proposed part 938 and that are issued for the purposes enumerated in paragraphs (a)(1) through (a)(4). The term "standby letter of credit," as defined in § 938.1, is intended to include those instruments that are commonly referred to as such; *i.e.*, LOCs that effectively guarantee the applicant's payment or performance in an underlying transaction with the beneficiary. The term does not include LOCs that are intended to serve as a short-term payment mechanism to finance the movement of goods (commonly known as "commercial" LOCs). The Finance Board considers "direct pay" LOCs, which are designed to act as the primary mechanism for satisfying an applicant's payment obligations over a period of time (for example, to make payments of principal and interest on commercial paper and medium-term notes) to be a form of standby LOC which FHLBanks would be authorized to issue under the proposed regulation.

Under paragraph (a) of proposed § 938.2, FHLBanks would be authorized to issue or confirm standby LOCs for any of four broad purposes: (1) To facilitate residential housing finance or other housing activity; (2) to facilitate the financing of targeted economic development projects; (3) to assist members with asset/liability management; or (4) to provide members with liquidity or other funding. This list of approved purposes would replace the more specific and restrictive list set forth in the Interim Guidelines. By replacing the specific list with the broader purposes set forth in paragraph (a) of § 938.2, the Finance Board intends to ensure that FHLBanks' use of standby LOCs is consistent with the FHLBank System's housing and community development mission and, at the same time, provide the FHLBanks with greater flexibility to respond to member needs for such credit. Under the proposed regulation, FHLBanks would determine, subject to Finance Board review and oversight, whether particular transactions fall within any of the above-described categories.

The term "residential housing finance" refers to the purchase or funding of "residential housing finance assets," or other activities that support the development or construction of residential housing. As defined in § 935.1 of the Finance Board's regulations, the term "residential housing finance assets" includes: Loans secured by residential real property; mortgage-backed securities; participations in loans secured by residential real property; loans financed by CIP advances (under the proposed Community Investment Cash Advance (CICA) rule, discussed below, reference to CIP advances would be amended to refer to loans or investments financed by advances made pursuant to a CICA program); loans secured by manufactured housing; or any other assets that the Finance Board determines to be residential housing finance assets. The term "residential housing finance," as defined in § 938.1 of the proposed regulation, also is intended to encompass activities that are aimed toward providing residential housing for individuals and families, but that do not fall within the existing regulatory definition of "residential housing finance assets," which refers only to loans and securities backed by loans. For example, a FHLBank would be permitted to issue a standby LOC to serve as a performance bond to secure a builder's performance in a housing construction project. Paragraph (a)(1) of § 938.2 is intended to provide the FHLBanks with the same scope of authority to issue and confirm housing-related standby LOCs that currently exists under the Interim Policy.

Economic development projects that would be eligible for support through a FHLBank standby LOC would include commercial, manufacturing, social service, public or community facility, and public or private infrastructure projects or activities that benefit families with incomes of 100 percent or less of area median income in urban areas, 115 percent or less of area median income in rural areas, or with an income at or below a target level established by a FHLBank to address unmet housing or economic development credit needs. Projects would be deemed to benefit such families if: The project is located in a neighborhood in which more than 50 percent of the families have incomes at or below the targeted income level; the project is located in a rural or urban Champion Community, a rural or urban Empowerment Zone, or rural or urban Enterprise Community; the project is located in a federally declared disaster area; the project involves property

eligible for a federal Brownfield Tax Credit; the project is located in an area affected by a federal military base closing or realignment; the project is located in an area identified as a designated community under the Community Adjustment and Investment Program; the annual salaries for at least 75 percent of the permanent full- and part-time jobs, computed on a full-time equivalent basis, created or retained by the project, other than construction jobs, are at or below the targeted income level; the project qualifies as a small business; or more than 50 percent of the families who otherwise benefit from (other than through employment) or are provided services by the project have incomes at or below the targeted income level.

These provisions and the concepts underlying them were developed as part of the Finance Board's proposed Community Investment Cash Advance (CICA) program regulation, which has been published elsewhere in this issue of the **Federal Register**. The proposed CICA Regulation would establish a general framework under which the FHLBanks may establish programs to provide advances to be used in support of financing for housing and economic development activities that benefit income-targeted families that may not benefit from advances made under the FHLBanks' existing Affordable Housing Programs (AHP) and Community Investment Programs (CIP).

Specifically, the proposed CICA Regulation would authorize each FHLBank to establish: A Rural Development Advance (RDA) program to provide advances to members and nonmember borrowers to finance economic development projects in rural areas that benefit families with incomes at or below 115 percent of the area median income; an Urban Development Advance (UDA) program to provide advances to members and nonmember borrowers to finance economic development projects in urban areas that benefit families with incomes at or below 100 percent of the area median income; and other CICA programs to provide financing for economic development projects benefiting families with incomes at or below a level established by the Bank to address unmet economic development credit needs (defined as those for which financing is not generally available, or is available at lower levels or under less attractive terms). Regulation of the existing CIP would also be subsumed within the CICA Regulation.

Under the Interim Guidelines, FHLBanks are permitted to issue standby LOCs to support only those

economic development activities that benefit families earning less than 80 percent of area median income, or that are located in a neighborhood in which 51 percent or more of the households earn less than 80 percent of area median income, for which a member could receive a CIP advance. Having determined that it may authorize FHLBanks to issue standby LOCs to support a wider array of activities than is currently permitted under the Interim Guidelines, the Finance Board sought ways to permit FHLBanks to respond better to member requests for LOC products while, at the same time, assuring that FHLBanks' use of standby LOCs is consistent with the public policy purposes of the FHLBank System. The inclusion of the CICA-related targeted economic development provisions, which already had been subject to much study and discussion in the process of developing the proposed CICA Regulation, as one parameter for FHLBank LOC use appears to meet both criteria by maximizing the ability of FHLBanks to benefit areas with unmet economic development credit needs, as well as furthering regulatory consistency.

A thorough discussion of the reasoning behind the Finance Board's inclusion of particular substantive criteria in its conception of targeted economic development may be found in the preamble to the proposed CICA Regulation, published elsewhere in this issue of the **Federal Register**. It is anticipated that, if and when the CICA and Standby LOC Regulations are promulgated as final rules, the Standby LOC Regulation will describe the economic activities that may be appropriately supported by FHLBank LOCs merely by cross-referencing the CICA Regulation, as opposed to including all of the CICA-related definitions therein. Because the CICA Regulation thus far has been published only as a proposed rule, the Finance Board found it appropriate to restate those definitions in their entirety within the proposed Standby LOC Regulation in order to make its scope more readily apparent to the reader.

Under paragraph (a) of proposed § 938.2, FHLBanks also would be permitted to issue standby LOCs to assist members with their asset/liability management and to provide members with liquidity or other funding. Although the Interim Guidelines permit FHLBanks to issue short-term LOCs to facilitate interest rate swaps and other transactions that assist in asset/liability management, such LOCs would no longer be limited to a term of five years or less, or limited only to QTL members,

under the proposed regulation. In addition, although liquidity and other funding purposes are not mentioned expressly in the Interim Guidelines, they have been included in the proposed regulation to make clear that the FHLBanks may use their LOC authority to further this central member-service function and to bring within the purview of the regulation permissible standby LOC activities that might not be easily traceable to a particular housing or economic development purpose, such as securing public unit deposits and IRC Section 936 deposits.

Paragraph (b) of proposed § 938.2 requires that FHLBank standby LOCs made to members be secured at the time of issuance for the full amount of the LOC by collateral described in paragraph (c) of that section. This would continue the requirement of the Interim Guidelines that LOCs be fully secured at the time of issuance, although, as discussed below, members would be able to use a wider range of collateral and would no longer need to pledge their FHLBank stock as additional collateral for LOCs. Although the Finance Board has concluded that, as a matter of law, the Bank Act does not necessarily require that LOCs be collateralized fully at the time of issuance, it has determined that such a requirement is advisable as a matter of safe and sound banking practice. The Finance Board requests comments on whether there are any circumstances under which the FHLBanks could safely and soundly issue LOCs that are not fully collateralized.

Paragraph (c) describes the types of collateral that are eligible to secure FHLBank standby LOCs issued on behalf of members. It provides that all LOCs may be secured with collateral that is eligible to secure FHLBank advances to members under § 935.9(a) of the Finance Board's regulations. 12 CFR 935.9(a). In addition, in order to facilitate the use of LOCs to support housing and targeted economic development activities and to permit greater access to LOCs by members that lack sufficient § 935.9(a)—eligible collateral, the proposed regulation also would permit members to secure LOCs that are issued for the purpose of facilitating residential housing finance or targeted economic development activities with: (1) secured or federally-guaranteed loans to small businesses (as defined by the Office of Thrift Supervision); (2) investment-grade obligations of state or local government agencies; and (3) "other real estate-related collateral" described in § 935.9(a)(4) of the regulations in excess

of the "30 percent of capital" limitation set forth in paragraph (a)(4)(iii) thereof.

Under the Interim Guidelines, LOCs may be secured only by collateral that is eligible to secure advances, regardless of the purpose for which the LOC is issued. Such collateral includes Small Business Administration—(SBA) guaranteed securities. However because most small business loans are not SBA-guaranteed, the proposed regulation, by permitting all secured or federally-guaranteed small business loans to be used as collateral for LOCs, could encourage members to provide financing for smaller or start-up businesses that often have a more difficult time accessing credit than well-established or larger enterprises. Expanded use of small business loans as collateral will support the FHLBanks' mission of providing support for targeted economic development lending—the targeted universe in this case being small commercial and business entities, including small farms. Commercial bank members and Community Development Financial Institution (CDFI) members, in particular, may have substantial amounts of such loans available to use as collateral.

Under the proposed regulation, an additional source of collateral for LOCs would be state and municipal bonds rated investment grade by a nationally-recognized rating agency (such as bonds rated BBB or better by Moody's or Bbb or better by Standard & Poor's). Under the Interim Guidelines, FHLBanks may accept real estate-related state and municipal housing bonds as collateral for LOCs only as part of the limited basket of other real estate-related collateral. See 12 CFR 935.9(a)(4)(iii). Expanding eligible collateral for LOCs to include investment grade state or municipal bonds could benefit members who hold such investments and who have insufficient advances-eligible collateral. Because there is an established secondary market for these bonds, they can be easily valued and, if necessary, liquidated by a FHLBank.

The proposed regulation also permits members to secure LOCs issued for housing finance or targeted economic development purposes with other real estate-related collateral in excess of the "30 percent of capital" limitation set forth in § 935.9(a)(4)(iii) of the Advances Regulation. 12 CFR 935.9(a)(4)(iii). If so permitted, members that have substantial amounts of such collateral, such as commercial banks, could expand their use of FHLBank LOCs. For example, members specializing in community development lending could pledge, without limit, loans secured by

community facilities, such as day care centers and health clinics and lenders in rural areas could pledge more of their farm loans.

The proposed regulation would permit each FHLBank to establish limits on the use of these additional types of collateral. FHLBanks accepting such collateral would be expected to include, as part of their standby LOC policies required under § 938.5(a)(1), policies and procedures for valuing and securing such collateral that are consistent with safe and sound banking practice. The Finance Board believes that any additional risks that might arise from the use of these additional types of collateral should be adequately managed in accordance with the collateral provisions of the Advances Regulation that are referenced in proposed § 938.5(d). Among other things, the Advances Regulation requires the FHLBanks to establish written procedures for determining the value of collateral, and to follow those procedures in ascertaining the value of a particular asset offered as collateral. See 12 CFR 935.12. The Advances Regulation also permits the FHLBanks 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. *Id.*

The Finance Board expects that if proposed part 938 is adopted as a final rule, each FHLBank will review its collateral valuation procedures, and will amend them as necessary to reflect the availability of these additional types of collateral to secure standby LOCs, before accepting such collateral. 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. Such appraisal should take into account the security of the loan itself, as well as any additional risks inherent in such collateral and each FHLBank's own ability to evaluate those risks. The Finance Board specifically requests comment on whether there are other assets that should be considered as eligible collateral for LOCs and whether the Finance Board should establish limits on these additional types of collateral based upon the assets that secure the loans themselves.

Section 938.3 of the proposed regulation governs FHLBank standby LOCs issued or confirmed on behalf of customers that have been certified as eligible nonmember mortgagees pursuant to § 935.22(b) of the Finance Board's regulations. 12 CFR 935.22(b). Paragraph (a) of proposed § 938.3 would authorize FHLBanks to issue or confirm

on behalf of nonmember mortgagees standby LOCs that are fully secured by Federal Housing Administration-(FHA) insured loans or Government National Mortgage Association (GNMA) securities backed by FHA-insured loans, for the same broad purposes for which FHLBanks may issue or confirm LOCs on behalf of member institutions. In addition, paragraph (b) of proposed § 938.3 would authorize FHLBanks to issue or confirm, on behalf of nonmember mortgagees that have qualified as state housing finance agencies (SHFAs) by meeting the requirements of § 935.22(d) of the regulations, 12 CFR 935.22(d), standby LOCs that are fully secured by collateral eligible under § 935.9(a) of the regulations, *id.* 935.9(a), to secure advances. Standby LOCs secured by such collateral would be required to facilitate residential or commercial lending that benefits individuals or families meeting the income requirements in section 142(d) or 143(f) of the IRC.

Proposed § 938.3 would continue the general policy of the Interim Guidelines by requiring that FHLBank LOCs issued on behalf of nonmember mortgagees be subject to the same limitations and restrictions that apply to advances made to nonmembers under section 10b of the Bank Act, 12 U.S.C. 1430b, and § 935.24 of the regulations, 12 CFR 935.24. In its legal review of the sources of statutory authority for issuance of LOCs by FHLBanks, the Finance Board determined that, unlike LOCs issued on behalf of members, the issuance of LOCs on behalf of nonmembers could not be considered to fall within the FHLBanks' payment processing authority, which expressly applies only to FHLBank dealings with members and financial institutions eligible to apply for FHLBank membership. See 12 U.S.C. 1431(e)(2). Thus, the Finance Board believes that FHLBanks should issue LOCs to a nonmember mortgagee only under the same conditions that would apply if the FHLBank were to enter into an advance commitment with that nonmember. Because the type of collateral that a FHLBank may accept to secure advances to nonmembers is linked, by statute, to the purpose of the advance, the purpose for which a LOC is issued on behalf of a nonmember also must govern the type of collateral that the FHLBank may accept to secure the LOC.

Section 938.4 of the proposed regulation governs the obligation of both members and nonmember mortgagees on whose behalf an FHLBank issues a LOC to reimburse the FHLBank for any funds drawn by the beneficiary under

the LOC. Paragraph (a) of proposed § 938.4 requires that, as part of the agreement pursuant to which a LOC is to be issued, a member or nonmember assume an unconditional obligation to reimburse the FHLBank fully for any amounts drawn by the beneficiary under the LOC by having available in its FHLBank deposit or transaction account on the day of the FHLBank's payment to the beneficiary sufficient funds to cover such payment. The requirement that an applicant assume an unconditional obligation to reimburse the FHLBank continues the policy of the Interim Guidelines and is consistent with the provisions of Article 5 of the Uniform Commercial Code (UCC), as revised in 1995, which provide that an issuer that has honored a presentation made by a beneficiary under a LOC is entitled to be reimbursed by the applicant in immediately available funds not later than the date of its payment of funds. See UCC 5-108(i) (1995).

In order to facilitate reimbursement of a FHLBank, to emphasize the applicant's responsibility to cover the amount of any draw under a LOC, to tie the FHLBanks' LOC activities more closely to their payment processing authority (in the case of LOCs issued on behalf of members) and for purposes of regulatory consistency, paragraph (a)(1) of § 938.4 requires that reimbursement by an applicant be accomplished through its FHLBank deposit account (if the applicant is a member) or transaction account (if the applicant is a nonmember, see 12 CFR 935.24).

Paragraph (b) of proposed § 938.4 requires FHLBanks to take prompt action to recover the funds due if an applicant fails to have available in its FHLBank deposit or transaction account on the day of a draw under a LOC sufficient funds to cover the draw. Despite this requirement, paragraph (b) of proposed § 938.4 authorizes an issuing FHLBank, at the request of a member or nonmember, but in its own discretion, to finance an applicant's repayment of a LOC draw by making an advance to the applicant. Of course, such an advance could be made only if the applicant is, at that time, willing and able to comply with the advances requirements of section 10 (if the applicant is a member) or section 10b (if the applicant is a nonmember) of the Bank Act, 12 U.S.C. 1430, 1430b, and part 935 of the Finance Board's regulations, 12 CFR part 935. For purposes of complying with the regulatory advance requirements, the "purpose" of an advance made to a member or nonmember under the conditions of proposed § 938.4(c) would be determined using the same standards

that apply to any other type of advance. See 12 CFR 935.13 & .14.

Section 938.5 of the proposed regulation sets forth certain miscellaneous provisions that would apply to all LOCs issued on behalf of members and nonmembers. paragraph (a)(1) of proposed § 938.5 requires that all LOCs issued on behalf of members or nonmembers be issued only pursuant to a written LOC policy established by the FHLBank to govern its standby LOC programs. Such a policy would be required to: (1) implement all statutory and regulatory provisions that apply to standby FHLBank LOCs; (2) to set forth underlying criteria to apply to the issuance or renewal of standby LOCs that is consistent with the criteria that must be applied to the underwriting of advances; and (3) set forth criteria regarding the pricing of standby LOCs, including any special criteria that could apply to LOCs issued to facilitate the financing of targeted economic development projects.

It is intended that paragraph (a)(1)(ii) of proposed § 938.5, regarding the application of underwriting criteria under the FHLBank's LOC policy at the time of the issuance or renewal of a LOC, apply also in cases where a LOC contains a provision stating that the LOC will automatically renew unless the FHLBank notifies the beneficiary of its intent not to renew the LOC. Such provisions must be carefully monitored so that the FHLBank can control its risk exposure. The renewal of any LOC pursuant to such a provision should be approved in the same manner as a renewal of a LOC that does not contain this provision. However, because an issued LOC cannot be canceled without agreement from the beneficiary, FHLBanks are encouraged to issue LOCs only for a limited term, with the potential for renewal if the account party remains creditworthy. This would give the FHLBanks an opportunity to reassess periodically their exposure on long-term transactions.

As a matter of safety and soundness regulation, paragraph (a)(2) of proposed § 938.5 would continue the policy of the Interim Guidelines by requiring that all LOCs issued by a FHLBank either contain a specific expiration date, or be for a specified term. This is consistent with Comptroller of the Currency and the OTS regulations on LOCs, which specifically require that LOCs issued by national banks and savings associations, as a matter of sound banking practice, be limited in duration or terminable periodically or at will upon notice or payment to the beneficiary. See 12 CFR 7.1016(b)(1)(iii) and 560.120(b)(1)(iii).

Similarly, paragraph (a)(3) of proposed § 938.5 would continue the policy of the Interim Guidelines by requiring that the transfer of a FHLBank LOC be approved in advance by the issuing FHLBank. A transfer of a letter of credit occurs when the beneficiary transfers to another party its right to draw under the LOC. Requiring approval by a FHLBank would ensure that a LOC could not be transferred without the FHLBank's knowledge.

Finally, paragraph (b) of proposed § 938.5 would apply to FHLBank LOCs issued on behalf of members and nonmembers certain provisions set forth in the Finance Board's Advances Regulation, 12 CFR part 935, including provisions regarding the FHLBank's right to require additional collateral or to limit the type of collateral that it will accept, and matters of collateral verification, safekeeping and valuation.

Proposed part 938 would not include many of the restrictions on FHLBank standby LOC transactions that currently are imposed by the Interim Guidelines. The Interim Guidelines require a member to purchase FHLBank stock when a FHLBank issues a LOC, which is an off-balance sheet item, on behalf of that member. This causes a decrease in the FHLBank's leverage because the FHLBank's outstanding stock is increased without a corresponding increase in on-balance sheet assets. Under proposed part 938, FHLBanks would no longer be required to include LOCs in the computation of a member's advances/FHLBank capital stock ratio, because the Finance Board no longer considers LOCs to be the legal equivalent of outstanding advances. Eliminating this requirement would remove the deleveraging effect of the current policy and would make FHLBank standby LOCs more attractive to members.

By applying uniform requirements to standby LOCs issued on behalf of any member, without regard to the QTL status of the member, proposed part 938 would not require that standby LOCs issued on behalf of non-QTL members be issued only for housing finance purposes, as is the case under the Interim Guidelines. In addition, proposed part 938 would not require that standby LOCs issued on behalf of non-QTL members be included with total FHLBank System advances and advances to non-QTL members for purposes of monitoring compliance with the FHLBank System's statutory 30 percent limit on advances to non-QTL members. See 12 U.S.C. 1430(e)(2). Again, the Finance Board has determined that these restrictions are not required by law because the Finance

Board no longer considers LOCs to be the legal equivalent of outstanding advances.

Removing these restrictions on standby LOCs issued on behalf of non-QTL members, many of which are actively involved in financing housing and economic development transactions, would expand the opportunities for FHLBanks to issue standby LOCs to support such housing and economic development activities. In addition, removal of these restrictions would enhance the ability of FHLBanks to assist non-QTL members with their liquidity needs.

The Interim Guidelines limit the use of standby LOCs with tax-exempt bonds to those issues designed to promote housing or commercial and economic development that benefits low- and moderate-income families or that is located in low- and moderate-income neighborhoods. Under IRC section 149, 26 U.S.C. 149, it is unclear whether tax-exempt bonds financing economic development would lose their tax-exempt status if supported by a FHLBank standby LOC. The Finance Board currently is working with Congress to resolve this issue legislatively. In the meantime, the Finance Board considers this issue to be a matter for the Internal Revenue Service to determine and, therefore, has not specified in the proposed regulation the types of tax-exempt bonds for which a FHLBank standby LOC may be issued.

The Interim Guidelines provide that FHLBank LOC confirmations may not be used solely to support a member's own LOC program or to increase a member's profitability. LOC confirmations serve essentially the same purpose, and incur for a FHLBank the same contingent liability, as the issuance of a LOC. A member's access to a FHLBank's LOC confirmation presumably would make a member's LOC more acceptable to a beneficiary and would help to increase a member's profitability. Because all of the products and services offered by a FHLBank to its members are designed to assist members improve their liquidity, to offer additional financing options to its customers, and consequently increase its income, the current restriction on confirmations appears to conflict with these goals. Therefore, this restriction has not been included in proposed part 938.

The Interim Guidelines limit the term of a FHLBank standby LOC issued on behalf of a QTL member to 5 years for non-housing finance purposes and 10 years for housing finance purposes, but impose no limit for issues that support a member's performance in interest rate swap transactions. The Interim

Guidelines limit the term of a FHLBank standby LOC issued on behalf of a non-QTL member to 10 years or less for housing finance. In contrast, FHLBanks may offer advances with maturities of any length consistent with the safe and sound operation of the FHLBank. See 12 CFR 935.6(a).

Expanding the terms for LOCs would benefit low-income housing tax credit transactions that often require a 15-year letter of credit. In addition, a longer term would permit LOCs to be used with industrial development and other bonds used to fund local economic development that typically have terms longer than 10 years. Because standby LOCs possess no more credit risk than an advance, there appears to be no reason to limit the maturity of a LOC as long as a FHLBank has established controls that ensure the safe and sound operation of the FHLBank. Therefore, the proposed regulation imposes no term limitations on FHLBank standby LOCs.

Proposed part 938 would not require that outstanding FHLBank LOCs be reflected on the books of the FHLBank as contingent liabilities, as is required under the Interim Guidelines, because this is already required under General Accepted Accounting Principles (GAAP), which the FHLBanks must follow. Finally, the requirement of the Interim Guidelines that FHLBanks must submit monthly LOC reports has not been included in the proposed regulation because this is already subsumed within the current general requirement that FHLBanks report monthly to the Finance Board on all FHLBank activities. See 12 CFR 934.7(e).

III. Regulatory Flexibility Act

The proposed 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 proposed rule, if promulgated as a final rule, will not have a significant economic impact on a substantial number of small entities.

List of Subjects in 12 CFR Part 938

Community development, Credit, Federal home loan banks, Housing, Mortgages.

Accordingly, the Finance Board hereby proposes to amend chapter IX, title 12, Code of Federal Regulations, to add a new 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.

Benefit. An economic development project is deemed to *benefit* families with incomes at or below a targeted income level if:

(1) The project is located in a neighborhood in which more than 50 percent of the families have incomes at or below the targeted income level;

(2) The project is located in a rural Champion Community, or a rural Empowerment Zone or rural Enterprise Community, as designated by the Secretary of Agriculture (in the case of projects located in rural areas);

(3) The project is located in an urban Champion Community, or an urban Empowerment Zone or urban Enterprise Community, as designated by the Secretary of HUD (in the case of projects located in urban areas);

(4) The project is located in a federally declared disaster area;

(5) The project involves property eligible for a federal Brownfield Tax Credit authorized by 26 U.S.C. 198;

(6) The project is located in an area impacted by a federal military base closing or realignment;

(7) The project is located in an area identified as a designated community under the Community Adjustment and Investment Program;

(8) The annual salaries for at least 75 percent of the permanent full- and part-time jobs, computed on a full-time equivalent basis, created or retained by the project, other than construction jobs, are at or below the targeted income level;

(9) The project qualifies as a small business; or

(10) More than 50 percent of the families who otherwise benefit from (other than through employment) or are provided services by the project have incomes at or below the targeted income level.

Champion Community means a community which developed a strategic plan and applied for designation by either the Secretary of Housing and Urban Development or the Secretary of Agriculture as an Empowerment Zone or Enterprise Community, but was designated a Champion Community.

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.

Economic development projects means:

(1) Commercial, manufacturing, social service, and public facility projects and activities; and

(2) The construction or rehabilitation of public or private infrastructure, such as roads, utilities, and sewers.

Family means one or more persons living in the same dwelling unit.

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.

Median income for the area means one or more of the following, as determined by the Bank:

(1) The median income for the area, as published annually by the Department of Housing and Urban Development;

(2) The applicable median family income, as determined under 26 U.S.C. 143(f) (Mortgage Revenue Bonds) and published by a State agency or instrumentality;

(3) The median income for the area, as published by the United States Department of Agriculture; or

(4) The median income for any definable geographic area, as published by a federal, state, or local government entity for purposes of that entity's housing programs, and approved by the Board of Directors of the Finance Board, at the request of a Bank, for use under the Bank's Community Investment Cash Advance (CICA) programs, as provided for in part 970 of this chapter.

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.

Metropolitan statistical area means a "metropolitan statistical area," as that term is defined by the U.S. Bureau of the Census.

Neighborhood means:

(1) A census tract or block numbering area;

(2) A unit of general local government with a population of 25,000 or less;

(3) A rural county;

(4) A trust or restricted Indian land, Native Hawaiian Home Land, or Alaskan Native Village; or

(5) A geographic location designated in comprehensive plans, ordinance, or other local documents as a neighborhood, village, or similar geographic designation that is within the boundary of but does not encompass the entire area of a unit of general local government.

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.

Rural area means:

(1) A unit of general local government or an unincorporated place outside a metropolitan statistical area that has a population of less than 30,000; or

(2) A trust or restricted Indian land, Native Hawaiian Home Land, or Alaskan Native Village.

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.

Targeted income level means:

(1) For projects or activities that benefit primarily individuals or families residing in an urban area, 100 percent of the median income for the area;

(2) For projects or activities that benefit primarily individuals or families residing in a rural area, 115 percent of the median income for the area; or

(3) An income level that is based on a percentage of median income established by the Bank to address unmet community investment credit needs.

Urban area means a unit of general local government or an unincorporated place that is:

(1) Within a metropolitan statistical area; or

(2) Outside a metropolitan statistical area and has a population of more than 30,000.

§ 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 the financing of economic development projects that benefit families with incomes at or below a targeted income level;

(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 § 938.4(a)(2), and that complies with the requirements set forth in paragraph (c) of this section.

(c) *Eligible collateral.* (1) Any standby letter of credit issued on behalf of a member may be secured by collateral that is eligible to secure advances under § 935.9(a) of this chapter. In making the calculation required under § 935.9(a)(4)(iii) 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 as "outstanding advances."

(2) A standby letter of credit issued on behalf of a member for a purpose described in paragraphs (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 the financing of economic development projects that benefit families with incomes at or below a targeted income level;

(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; and

(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 economic development projects that benefit families with incomes at or below a targeted income level;

(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.

(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(e), 935.11 and 935.12 of this chapter.

Dated: April 22, 1998.

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

Bruce A. Morrison,

Chairman.

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