



Federal Housing Finance Board

October 28, 1998

OPINION OF THE OFFICE OF GENERAL COUNSEL

ISSUES AND CONCLUSIONS:

- (1) Issue: Does a Federal Home Loan Bank (FHLBank) have the legal authority to issue a standby letter of credit (LOC) on behalf of members other than pursuant to its express power to make advances?
Conclusion: Yes.
- (2) Issue: May a FHLBank accept as security for its outstanding LOCs collateral other than that eligible to secure advances under section 10(a) of the Bank Act?
Conclusion: Yes.
- (3) Issue: May the current policy requirement that standby LOCs issued on behalf of members be included in the computation of a member's advances-to-FHLBank capital stock ratio be eliminated?
Conclusion: Yes.
- (4) Issue: May the FHLBanks issue standby LOCs to support the financing of targeted economic development projects, to provide members with liquidity or other funding, or to assist members with asset/liability management without regard to a member's qualified thrift lender (QTL) status?
Conclusion: Yes.
- (5) Issue: May nonmember borrowers have the same access to FHLBank standby LOCs, with the same restrictions and limitations thereon, as members?
Conclusion: No.

In conjunction with the proposed amendment and regulatory codification of existing policy guidelines governing FHLBank standby LOC transactions, the Federal Housing Finance Board's (Finance Board) Office of General Counsel (OGC) has been asked to review the authority under which the FHLBanks may engage in standby LOC transactions. Accordingly, OGC has reviewed the relevant statutory authority, prior legal opinions and the agency's Interim Policy Guidelines for FHLBank Standby LOCs (Interim SLOC Policy), see Finance Board Res. No. 93-63 (July 28, 1993), to determine if all of the current restrictions on the FHLBanks' issuance of standby LOCs are required by the Federal Home Loan Bank Act (Bank Act). 12 U.S.C. §§ 1421-49 (1994).

I. Background

A. Explanation of and Reasons for Letters of Credit. in General

A LOC is one in a series of three related, but independent, agreements under which a bank or other entity (called the "issuer"), at the request of a customer (called the "applicant"), engages to honor drafts or other demands for payment made by a third party (called the "beneficiary") upon compliance with the conditions specified in the LOC. See U.C.C. § 5-102 (1995). Typically, a LOC is issued in order to facilitate the consummation of a separate agreement between the applicant and the beneficiary and, although a LOC is legally distinct from a guaranty,¹ it essentially guarantees the payment of money or performance of other duties under that contract. See John F. Dolan, *The Law of Letters of Credit* ¶ 2.02 (3d ed. 1996). The LOC is issued pursuant to a third agreement between the applicant and the issuer, under which the issuer agrees to issue the LOC on behalf of the applicant and the applicant agrees to reimburse the issuer for any amounts paid under the LOC and any fees charged for the service.

In contrast to a traditional "commercial" LOC, which functions as a payment mechanism, a "standby" LOC essentially is a financing mechanism. See Comptroller's Release on Letters of Credit (hereinafter "Comptroller's Release"), [1974 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 96,301 at 81,415 (July 1, 1974). That is, whereas the issuer of a commercial LOC engages to make payment upon performance of the underlying contract by the beneficiary (usually the delivery of goods under a contract of sale), a standby LOC is payable upon certification by the beneficiary that the applicant has failed to perform its duties under the underlying contract, and thereby serves to "guarantee" payment or performance by the applicant.

¹ A LOC differs from a guaranty in that, while the latter represents a secondary obligation of a guarantor that is contingent upon the default of the principal, a LOC represents a direct and primary obligation of the issuer dependent only upon the fulfillment of the terms of the LOC by the beneficiary (usually the presentation of a draft). Harry Hatfield, *Letters of Credit* 1-2 (3d ed. 1981).

² Although standby LOCs normally are intended to be payable upon default of the applicant, the payment obligation is not actually contingent on the default itself, but only upon the beneficiary's presentation of the documents specified in the LOC. Dolan, *supra*, ¶ 1.07[2]; see Hatfield, *supra*, at 2 (stating that a LOC "is treated independently of any contract or arrangement to which it may be ancillary"). Such documents may include a conclusory certification that the applicant has not performed according to the contract, but a standby LOC is "often clean in that

Thus, the issuer of a standby LOC essentially "lends" its credit to the often less creditworthy applicant, thereby allowing the applicant to consummate a transaction that it otherwise might not have been able to do as cheaply, or at all. For example, a standby LOC may be used as a credit enhancement "to improve the marketability of commercial paper by guaranteeing that the [issuer of the LOC] will discharge at maturity the obligation evidenced by the paper" upon the failure of the issuer of the paper to do so. See Comptroller's Release at 81,415. Examples of other uses are numerous and include: securing the balance on promissory notes, guaranteeing the payment of development bonds and other securities, and securing the balance due on leases. See Dolan, *supra*, at ¶ 1.06.

B. FHLBank System Use of Standby LOCs

1. FHLBB Policies and Legal Memoranda

Although the Bank Act does not expressly address LOCs, the FHLBanks have been permitted to engage in standby LOC transactions since 1983, when the former Federal Home Loan Bank Board (FHLBB) first adopted its "Policy Guidelines for Issuance of FHLBank Standby Letters of Credit" (FHLBB SLOC Policy). See FHLBB Minute Entry (Nov. 30, 1983). Underlying the FHLBB's adoption of its original SLOC Policy was a May 27, 1983 memorandum in which the FHLBB General Counsel opined that the FHLBanks have the power to issue standby LOCs and to disburse payments to third parties pursuant to the presentment of LOC drafts. See Memorandum from Thomas P. Vartanian, FHLBB General Counsel, to James R. Silkensen, Acting Director, FHLBB Office of District Banks (May 27, 1983) at 12 (hereinafter Vartanian Memo).

While recognizing that the Bank Act does not expressly permit FHLBanks to issue LOCs, the Vartanian Memo concluded that:

a FHLBank's issuance of a standby letter of credit, which is considered the functional equivalent of a loan between the -Issuer and the [Applicant] 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. [12 U.S.C. § 1430.] Further, . . . the FHLBank's obligation to a third party (the Beneficiary of the credit) under a standby letter of credit is an incidental and adjunctive aspect of a FHLBank's lending authority, provided that the member has the unqualified and unconditional obligation to reimburse the FHLBank upon its disbursement to the beneficiary under the credit. This reimbursement may be in the form of a debit to the member's account at the FHLBank or a collateralized advance or some combination thereof.

Vartanian Memo at 10 (footnotes omitted).

the beneficiary may draw upon it without any documents to support his draft or demand for payment." Dolan, *supra*, ¶ 1.07[2]. "The summary nature of these documents reflects the right of the beneficiary to effect payment under the credit without satisfying [the issuer] that the applicant has not, in fact performed." *Id.*

The Vartanian Memo 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 "also may be considered properly an adjunctive and incidental aspect of a FHLBank's payment instrument processing authority under section 11(e)(2) of the Bank Act." Id. Noting that such payment instrument processing authority extends only to drafts issued by, or drawn on the FHLBank deposit account of' a member institution, the Vartanian Memo nonetheless concluded 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," so long as "the disbursement process under the [LOC] is directly linked to a FHLBank (demand deposit) account of the member at: whose request the [LOC] was issued by the FHLBank." Id.

After concluding that the FHLBB could authorize the FHLBanks to issue standby LOCs to facilitate members' transactions, the Vartanian Memo suggested that, in order to "tie such services to the FHLBanks' express power to make advances" and to "lessen the operational liability of the FHLBanks," the FHLBB place the following restrictions on the FHLBanks' LOC activity: (1) applications for LOCs should be reviewed in accordance with the FHLBank's standard credit policies; (2) all LOCs should be "fully collateralized as an advance at the time of its issuance and included in the computation of the member's advances/asset and advances/FHLBank stock ratios unless the member places funds to cover the expected disbursements in a segregated account placed under the complete dominion of the FHLBanks;" (3) LOCs should be transferable only to an agreed party; (4) outstanding LOCs should be reflected on the FHLBank's balance sheet as contingent liabilities; (5) FHLBanks should issue only "clean" LOCs (that is, the FHLBanks should not have to examine any documentation supporting payment); and (6) LOCs should be issued only in accordance with FHLBB guidelines. Id. at 11.

The 1983 FHLBB SLOC Policy imposed all of the foregoing requirements on FHLBank standby LOC transactions. While the FHLBB SLOC Policy was revised in 1985 and again in 1989 to permit wider use of FHLBank standby LOCs, the Policy continued to impose upon LOCs the same legal restrictions that apply to outstanding FHLBank advances.

2. Finance Board Policies and Legal Opinions Rewarding the FHLBanks' Authority to Issue Standby LOCs

Since its establishment in 1989, the Finance Board has based the provisions of its standby LOC policies on the reasoning set forth in the Vartanian Memo. A 1991 OGC memorandum reaffirmed the FHLBanks' authority to issue standby LOCs, specifically citing the Vartanian Memo and the reasoning set forth therein as one of the bases for this conclusion. See Memorandum from Jon Boustany, Attorney-Advisor, through Beth L. Climo, General Counsel, to J. Stephen Britt, Executive Director (May 3, 1991) (hereinafter Boustany Memo). Specifically, OGC opined therein that, because the FHLBanks derive their authority to issue standby LOCs from their authority to make secured advances under section 10(a) of the Bank Act, the requirements applicable to advances must apply equally to standby LOC transactions. Consequently, the Boustany Memo concluded (as does the Vartanian Memo) that standby LOCs must be fully secured by collateral eligible to secure advances, may only be issued on behalf of

member institutions and are includable in each member's advances to FHLBank capital stock ratio.

Notably, the Boustany Memo also offered the possibility that' by basing FHLBank LOC authority solely upon the FHLBanks' section 11(e)(2)(A) payment processing authority, the FHLBanks might be permitted to issue unsecured LOCs, assuming that payment on the LOC draft were linked to the member/applicant's FHLBank deposit account. However, the Memo queried whether the member would need to maintain an amount of cash in its account equal to the value of the LOC during the entire term of the LOC because "any overdraft protection [resulting from failure of the member to maintain sufficient deposits to cover the LOC] could be considered an extension of credit by the [FHL]Bank which is required to be collateralized under section 10(a)." Boustany Memo at 5-6. Noting that the maintenance of such deposits would defeat much of the purpose of a LOC, the Boustany Memo ultimately concluded that to consider FHLBank LOCs to be authorized as outstanding advances under section 10(a) of the Bank Act was the "better" legal approach. *Id.* at 6.

3. FHLBanks' Use of LOCs Under the Interim Policy Guidelines for Standby LOCs

FHLBank participation in standby LOC transactions currently is governed by the Finance Board's Interim SLOC Policy, the requirements of which are in conformity with the legal analyses set forth in the Vartanian and Boustany Memos. The Interim SLOC Policy permits FHLBanks to issue or confirm³ standby LOCs on behalf of member institutions in order to facilitate: (a) purchase of, or commitment to purchase, mortgage loans, where the LOC functions as a performance bond; (b) collateralization of public unit deposits; (c) collateralization of Internal Revenue Code section 936 deposits; (d) interest rate swaps and other transactions that encourage or assist the asset/liability management of members; and (e) other transactions that promote home financing, housing activity, or the financing of -commercial and economic development activities that benefit low- and moderate-income families, or that are located in low- and moderate-income neighborhoods? See *id.*

The Policy requires that all FHLBank standby LOCs comply with the provisions of the Finance Board's Advances Regulation, 12 C.F.R. part 935, including: that LOCs must be fully collateralized at the time of issuance with collateral eligible to secure advances under section 935.9(a) of the Regulation,⁵ *id.* 935.9(a); that LOCs issued on behalf of members be included

³ A LOC confirmation occurs when a bank that is more acceptable to the beneficiary than the issuing bank (usually one that is geographically closer to the beneficiary) "signs on" to the LOC and agrees to make payment thereunder upon the failure of the issuer to do so. See Dolan, *supra*, ¶ 1.03. The Interim SLOC Policy permits the FHLBanks to issue LOC confirmations, and the legal basis behind their power to do so is identical to that which applies to the issuance of LOCs. For the sake of brevity, this memorandum refers only to LOC issuance, but the analysis and conclusions contained herein pertain to confirmations as well.

⁴ With respect to the latter use, FHLBanks often issue standby LOCs as part of their AHP and CIP programs to help to fund projects meeting the criteria of those programs. Because the FHLBB and the Finance Board have considered a standby LOC to be an advance, each standby LOC issued by a FHLBank to facilitate the funding of a qualifying project counts as a CIP advance, made at the full face amount of the LOC.

⁵ The Finance Board's current interpretation of this requirement calls for collateralization of the full amount of the LOC, as if it were an outstanding advance to the member.

in computations of the member's advances-to-FHLBank capital stock ratio; that LOCs with terms of more than five years, and all LOCs issued on behalf of non-QTL members, be issued only to support housing finance; and that LOCs issued on behalf of non-QTL members be included in the calculation of the statutory limit on total FHLBank System advances to non-QTL members. See *id.*

In conjunction with the development of a standby LOC regulation that would codify more formally FHLBank standby LOC authority, OGC has been asked to consider: (1) whether, in addition to collateral eligible to secure advances under section 10(a) of the Bank Act, a FHLBank may accept certain other high-quality collateral (e.g., secured or guaranteed small business loans, obligations of state or local governments, or "other real estate related collateral" in excess of the statutory limitation thereon) to secure outstanding LOCs at the time of issuance; (2) whether the current requirement that standby LOCs issued on behalf of members be included in the computation of the member's advances-to-FHLBank capital stock ratio may be eliminated; (3) whether, in addition to the support of housing finance, the Finance Board may permit FHLBanks to issue on behalf of members standby LOCs to support the financing of targeted economic development projects,⁶ to provide members with liquidity or other funding, or to assist members with asset/liability, management; (4) whether, assuming that FHLBanks may issue standby LOCs for these expanded purposes, non-QTL members may be afforded access to such LOCs; and (5) whether nonmember borrowers may have the same access to FHLBank LOCs, with the same restrictions and limitations thereon, as members.

II. Analysis

As explained in the Vartanian and Boustany Memos, because a FHLBank standby LOC may be regarded as the functional equivalent of an outstanding advance, FHLBank issuance of standby LOCs is authorized under section 10(a) of the Bank Act. However, it is not necessary to view a LOC as an outstanding advance, or to subject LOCs to all of the statutory restrictions and limitations that apply to outstanding advances, in order to consider the issuance of a standby LOC to be a permissible activity for a FHLBank under the Bank Act. FHLBanks also may be authorized to engage in standby LOC transactions as part of the exercise of their deposit-taking and payment processing powers under section 11(e) of the Bank Act, 12 U.S.C. § 1431(e), and their incidental power 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). A LOC regulation or policy grounded in one or both of the latter legal approaches could afford a FHLBank considerably more freedom, within the bounds of safety and soundness, in their standby LOC operations.

⁶ Such projects 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 of area median income or less in urban areas, 115 percent of area median income or less in rural areas, or an income target established by a Bank to address unmet housing or economic development credit needs.

A. FHLBanks May Undertake All the Functions of an Issuer of a Standby LOC Pursuant to Their Section 11(e) Deposit-Taking and Payment Processing Authorities

While both the Vartanian and Boustany Memos used the FHLBank deposit-taking and payment processing provisions of section 11(e) of the Bank Act as a partial or alternative source for FHLBank standby LOC authority, both Memos relied primarily upon the advances provisions of section 10(a) in concluding that FHLBanks are authorized to engage in standby LOC transactions. In fact, section 11(e), also provides sufficient independent authority to permit a FHLBank to enter into an issuer/applicant contract with its member, to issue a standby LOC on behalf of that member and to make payment on a draft thereunder.

1. Under Section 11(e) of the Bank Act, FHLBanks May Be Drawees on Drafts Drawn On Members

Section 11(e)(1) of the Bank Act provides that "[e]ach [FHL]Bank shall have power to accept deposits made by members of such [FHL]Bank . . . upon such terms and conditions as the [Finance] Board shall prescribe, but no [FHL]Bank shall transact any banking or other business not incidental to activities authorized by this chapter." 12 U.S.C. § 1431(e)(1). In addition, section 11(e)(2)(A) states:

The [Finance] Board may, subject to such rules and regulations, including definitions of terms used in this paragraph, as the [Finance] Board shall from time to time prescribe, authorize [FHL]Banks to be drawees of, and to engage in, or be agents and 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 [FHL]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 [Finance] Board shall find necessary for the exercise of any such authorization.

12 U.S.C. § 1431(e)(2)(A).

Section 11(e)(2) sanctions FHLBank payments on drafts presented by a third party beneficiary under a LOC in that it authorizes the Finance Board to permit FHLBanks to "be drawees of. . . drafts, or any other negotiable or nonnegotiable items or instruments of payment drawn on or issued by members of any [FHL]Bank" ⁷ Clearly, an issuing FHLBank would be the "drawee" of - that is, the financial institution directed to make payment upon⁸ - any draft

⁷ A draft is a "signed, written order by which one party (drawer) instructs another party (drawee) to pay a specified sum to a third party (payee)." John Downes and Jordan E. Goodman, *Barron's Finance and Investment Handbook* 244 (2d ed. 1987).

⁸ A "drawee" is a "person to whom a bill of exchange or draft is directed, and who is requested to pay the amount of money therein mentioned. The drawee of a check is the bank on which it is drawn." *Black's Law Dictionary* 444 (5th ed. 1979). In commercial law, the term "drawee" is used interchangeably with the term "payor." See James V. Vergari and Virginia V. Shue, *Checks, Payments and Electronic Banking* 572 (PLI 1986).

presented to it pursuant to a standby LOC issued by the FHLBank. In addition, although a LOC draft can not be considered to be "issued by" the member/applicant, such a draft may be considered to be "drawn on" the member/applicant.

2. A Draft Paid By a FHLBank Under a LOC Is "Drawn On" a Member's Account If the Member Has an Obligation to Reimburse the FHLBank and This Reimbursement Is Drawn On the Member's FHLBank Deposit Account

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 could 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/applicant's FHLBank deposit account in the amount of the LOC draft; and (2) the member/applicant 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. In fact, these requirements are imposed by the existing Interim LOC Policy⁹ and, in commercial practice, are common to standby LOC transactions generally." 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.

3. Section 11(e) Permits FHLBanks to be Drawees on Drafts, Including LOC Drafts, Drawn on a Member's FHLBank Deposit Account

As mentioned, section 11(e)(2) permits the Finance Board to "authorize [FHL]Banks to be drawees of, and to engage in, or be agents and intermediaries for, or otherwise participate or assist in, the collection and settlement of' drafts that are "drawn on . . . members." 12 U.S.C. § 1431(e)(2). Read in the context of this broad enumeration of authorities, the phrase "drawn on . . . members of any [FHL]Bank" could refer both to a draft that is drawn on a member's account at a FHLBank and to a draft on which a member is named as the drawee financial institution. However, when considered only in the context of a FHLBank's power to act as drawee, the phrase "'drawn on . . . members of any [FHL]Bank" necessarily must refer only to drafts drawn on a member's FHLBank deposit account because a FHLBank and its member can not be simultaneous drawees of the same draft. See 2A Sutherland Statutory Construction ¶ 46.07 (5th ed. 1992) (statutory interpretations leading to absurd results are to be avoided).

The Vartanian Memo itself construes the term "drawn on" to permit FHLBanks to make payment on drafts "drawn on a member institution's account at the FHLBank." Vartanian Memo

⁹ By requiring that standby LOCs comply with the Finance Board's Advances Regulation, the Interim LOC Policy implicitly requires that a member reimburse the FHLBank for payments made to the beneficiary on a LOC draft. In addition, the Policy explicitly requires that all disbursements made under FHLBank LOCs "be linked directly to an account established at the FHLBank."

¹⁰ See Dolan, *supra*, ¶¶ 7.05[1] & [5]. The 1995 LOC provisions of the UCC provide that "[a]n issuer that has honored a presentation as permitted or required by this article . . . is entitled to be reimbursed by the applicant in immediately available funds not later than the date of its payment of funds." UCC § 5-108(i) (1995).

at 10. Even before the addition of section 11 (e)(2) to the Bank Act by the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980, Pub. L. No. 96-221, § 311,94 Stat. 149 (1980), the FHLBB had long permitted FHLBanks, as an activity incidental to their section 11(e) deposit-taking powers, to disburse deposit account funds to members pursuant to checks, drafts, money orders and other similar instruments of payment. See, e.g., FHLBB Res. No. 8081 (Feb. 8, 1955). This existing power was recognized by Congress in the legislative history of DIDMCA, wherein it stated that member deposits had already been "subject to withdrawal by check, money order and other instruments," see H.R. Rep. No. 842 at 74, and that the addition of section 11(e)(2) was intended to "expand[] the [FHL]Banks' existing authority to engage in the processing and settlement of negotiable orders or other instruments of payment." See *id.*

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 in this paragraph" and to permit the FHLBanks to engage in such incidental activities as the Finance Board "shall find necessary for the exercise of any . . . authorization" thereunder. 12 U.S.C. § 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 the factors mentioned above, section 11(e)(2) would permit the Finance Board to authorize FHLBanks to act as drawee on drafts drawn on a member's FHLBank deposit account. Because 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) also would permit 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.

4. The Power of the FHLBanks to Issue Standby LOCs is Incidental to Their Express Power to Be Drawees on Drafts Drawn on a Member

In addition to its express authorizations, section 11(e)(2) of the Bank Act permits FHLBanks "to have such incidental powers as the [Finance] Board shall find necessary for the exercise of any . . . authorization" thereunder. See 12 U.S.C. § 1431(e)(2). As such, section 11(e) not only provides authority for FHLBanks to make payments on drafts presented under standby LOCs, but also provides sufficient incidental authority for FHLBanks to contract to issue and to issue standby LOCs.

As discussed in detail above, a prospective issuer of a standby LOC first enters into a contract with the applicant under which the issuer agrees to issue a LOC to facilitate an independent transaction between the applicant and the beneficiary. Pursuant to this contract, the issuer issues a standby LOC on behalf of the applicant, under which the issuer agrees to honor any draft or equivalent demand for payment that is presented by the beneficiary and that conforms to the requirements of the LOC. In the event that the beneficiary presents a conforming draft, the issuer has a primary legal obligation to make payment upon it without inquiry into any external circumstances (including the status of the applicant's performance under its contract with the beneficiary). If the LOC expires before the beneficiary has presented a draft thereunder, all obligations of the issuer to the beneficiary are extinguished.

As such, 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.¹¹ 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 the Vartanian Memo did) 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.

Having concluded 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, it does not require an expansive interpretation of the words "incidental" and "necessary" to conclude also that the power to agree to undertake such an obligation (by contracting therefore with the member/applicant) and the power to undertake the obligation (by issuing the standby LOC) are "incidental powers . . . necessary for the exercise of the FHLBank's authority to make payment on the LOC draft."¹² See *Arnold Tours v. Cump*, 472 F.2d 427 (1st Cir. 1972) (holding generally that a national bank's activity is authorized as an incidental power "necessary to carry out the business of banking" under the National Bank Act if the activity is "convenient or useful" in connection with the performance of one of the bank's express powers); Memorandum from Eric M. Raudenbush, Attorney-Advisor, through Deborah F. Silberman, Acting General Counsel, to Bruce A. Morrison, Finance Board Chairman (Dec. 18, 1996) (MPF Memorandum) (analyzing the incidental powers of the FHLBanks by reference to the incidental powers of national banks). 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.

5. Cost of Capital Adjustment Factor Under Section 11(e)(2)(B)

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 C.F.R. part 943. Specifically, the pricing of services is addressed in section 943.6(b), which

¹¹ Under the 1995 LOC provisions of the UCC, the term "letter of credit" is defined to include "a definite undertaking . . . by an issuer to a beneficiary at the request or for the account of an applicant. . . to honor a documentary presentation by payment or delivery of an item of value." UCC § 5-102(10). "Presentation" is defined to mean the "delivery of a document to an issuer for honor, UCC § 5-102(12), and, in turn, "document" is defined to include "a draft or other demand . . . presented in a written or other medium permitted by the [LOC]. . . which is capable of being examined for compliance with the terms and conditions of the [LOC]." UCC § 5-102(6).

¹² Nothing in this OGC Opinion is intended to suggest that the incidental powers language set forth in section 11(e)(2)(A) of the Bank Act, 12 U.S.C. § 1431(e)(2)(A), refers solely to the FHLBanks' payment processing powers.

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, for any draw made by a beneficiary under a standby LOC, the applicant must be charged a payment processing fee calculated in accordance with the requirements of section 943.6(b) of the Finance Board's regulations.

B. FHLBank Issuance of a Standby LOC Is Effectively a Commitment to Make an Advance and, As Such, the Power to Issue a LOC is Incidental to the FHLBanks' Advances Authority

Both the Vartanian and Boustany Memos found FHLBank standby LOC activities to be authorized under the FHLBanks' section 11(e) deposit-taking and payment processing powers. However, relying on the premise that a standby LOC is the functional equivalent of an outstanding advance, both ultimately focused on the advances provisions of section 10(a) of the Bank Act as the primary source of authority for FHLBanks to engage in standby LOC transactions. While, as discussed in detail above, section 11(e) provides sufficient independent authority to permit a FHLBank to engage in a standby LOC transaction, the Vartanian and Boustany Memos correctly concluded that such activity is also authorized as part of the FHLBanks' statutory advances powers. However, 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.

1. The Power of FHLBanks to Commit to Make Advances. Is Incidental to Their Power to Make Advances Under Section 10 of the Bank Act

Section 9 of the Bank Act provides that "[a]ny member of a [FHL]Bank shall be entitled to apply in writing for advances."¹³ 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.¹⁴ 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 this chapter and all things incident thereto." See id. § 1431 (a).

OGC has determined previously that it is appropriate to look to the federal court opinions addressing the incidental powers of national banks to establish the reasonable scope of the term "all things incident thereto," as used in section 11(a) of the Bank Act. Under this line of cases, an activity reasonably may be considered to be incidental to an express power, inter alia, if it is "convenient and useful in connection with the performance of the bank's established activities

¹³ Section 935.4(a) of the Advances Regulation expands upon section 9 of the Bank Act by permitting FHLBanks to accept "oral or written applications for advances" from their members. See 12 C.F.R. § 935.4(a).

¹⁴ Section 935.9(a) of the Advances Regulation generally repeats the collateral requirements of section 10(a) of the Bank Act by requiring the FHLBanks to obtain and maintain security interests in the statutorily-eligible collateral, which is described in more detail in the Regulation. See 12 C.F.R. §935.9(a).

pursuant to its express powers." See *Arnold Tours v. Camp*, 472 F.2d at 432; MPF Memorandum at 3-8. Clearly, 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, see 12 U.S.C. § 1430(a), and to accept applications for advances, see *id.* § 1429. The Finance Board has acknowledged the existence of this incidental power in section 935.5(g) of its Advances Regulation, 12 C.F.R. § 935.5(g), which restricts the funding of "commitments for advances" to insolvent members."

2. Because a Standby LOC Is a Form of Advance Commitment, FHLBanks Also Have Incidental Authority to Engage in Standby LOC Transactions on Behalf of Members

A standby LOC may be considered to be a form of commitment in that both credit products 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. As mentioned, earlier, by issuing a standby LOC, an FHLBank undertakes to disburse funds to the beneficiary upon the beneficiary's presentment of a conforming draft. This differs technically from a commitment in that the latter represents an undertaking to disburse funds directly to the member. However, a standby LOC may be characterized as a commitment to make an advance to the member/applicant indirectly by paying the funds to the beneficiary in satisfaction of an obligation of the member/applicant.

This characterization is supported by the fact that a FHLBank's agreement to disburse funds pursuant to a LOC draft is undertaken at the request of, and for the benefit of, the member/applicant.¹⁵ The Finance Board can further tie standby LOC authority to the FHLBanks' power to enter into advance commitments by authorizing the FHLBanks to issue standby LOCs only when: (1) the FHLBank requires the member/applicant to assume 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.

That it is possible to envision an advance commitment/disbursement scenario that is nearly identical to that which occurs under a standby LOC also is an indication that it is not unreasonable to consider a standby LOC to be a form of advance commitment. Conceivably, a FHLBank member might enter into an advance commitment with the FHLBank in anticipation of having to satisfy a lump-sum obligation at some point in the future. When the obligation came due, the member might choose to draw-down the advance and settle its obligation with the

¹⁵ One could also consider the power to enter into an advances commitment to be authorized not merely as an incidental activity, but as an activity "necessary for carrying out the provisions" of the Bank Act." See 12 U.S.C. § 1431(a).

¹⁶ As discussed at length above, an issuer will issue a standby LOC on behalf of an applicant in order to facilitate a separate transaction between the applicant and the beneficiary - that is, the issuer effectively guarantees the performance of the applicant. Presumably, without this effective guaranty, the applicant would be unable to enter into the transaction with the beneficiary, or, at least, would be unable to participate in the transaction on terms as favorable as those obtainable with the use of a FHLBank standby LOC.

proceeds thereof by paying these funds to its third party creditor. In fact, nothing in the Bank Act or the Advances Regulation would prohibit the FHLBank from making the disbursement, at the member's request, directly to the member's creditor, as is done under a standby LOC, so long as the transaction otherwise complies with the applicable advances requirements. See 12 U.S.C. § 1430; 12 C.F.R. part 935.

Finally, under both a traditional advance commitment and a standby LOC, the FHLBank's obligation to extend an advance is contingent upon its member's ability to meet the statutory and regulatory requirements to receive an advance at the appropriate time. In the case of a commitment, the FHLBank agrees to make funds available to its member upon the member's request. In the event that the member requests disbursement of funds, it must, at that time, meet all of the statutory and regulatory requirements necessary to obtain an advance. If it does not, the FHLBank should not make the advance.

Similarly, in the event that the FHLBank is called upon to disburse funds to a beneficiary under a standby LOC and the member/applicant is unwilling or unable to fulfill its obligation to make equivalent funds available immediately to reimburse the FHLBank, the FHLBank may consider the disbursement to be an advance made to the member on whose behalf the standby LOC was issued. As in the case of a traditional advance, a FHLBank's disbursement to a LOC beneficiary should not be considered to be an advance if the member/applicant is unable, at the time the disbursement is made, to meet the statutory and regulatory requirements necessary to receive an advance. In this case, the FHLBank should consider its member to be in default on the issuer/applicant contract and should begin to take steps to recover the funds that the member/applicant has failed to repay through foreclosure upon the collateral that secured the LOC, or by other appropriate means.

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.

C. The Fifth Circuit Court of Appeals' Holding in *REW Enterprises v. Premier Bank* Regarding the LOC Powers of Federal Land Banks Does Not Apply to the Federal Home Loan Banks

In *REW Enterprises v. Premier Bank*, 49 F.3d 163 (5th Cir. 1995), the United States Court of Appeals for the Fifth Circuit held to be ultra vires a standby LOC issued by the Federal Land Bank (FLB) of Jackson (Mississippi). At the time of the transaction in question, FLBs were one of three types of banks, along with Banks for Cooperatives (BCs) and Production Credit Associations (PCAs), that comprised the Farm Credit System. FLBs were authorized by statute to:

make or participate with other lenders in long-term real estate mortgage loans in rural areas . . . and make continuing commitments to make such loans under specified circumstances, or extend other financial assistance of a similar nature to eligible borrowers, for a term of not less than five nor more than forty years.

12 U.S.C. § 2014 (1982). FLBs were also authorized to "[e]xercise . . . all such incidental powers as may be necessary or expedient to carry on the business of the bank." Id. §2012(21).

In its analysis, the court noted that Congress had amended the Farm Credit Act in 1971 to give BCs and PCAs - but not FLBs -- the express power to issue guaranties. Subsequently, the Farm Credit Administration interpreted this statutory provision as including the authority to issue LOCs and promulgated a regulation permitting BCs and PCAs - but not FLBs - to issue LOCs. See 12 C.F.R. § 614.4810 (1982). Finding that "Congress could have authorized [FLBs] to issue letters of credit, but chose not to," the court then concluded that "[b]ecause [FLBs] were not authorized by statute to issue letters of credit, to do so was an ultra vires act." REW, 49 F.3d at 166.

The court rejected the argument that the FLBs had incidental authority to issue LOCs pursuant to their statutory authorization to exercise "all such incidental powers as may be necessary or expedient to carry on the business of the bank." Id. While conceding that the power to issue LOCs is part of the traditional "business of banking" that National Banks are authorized by statute to carry out, see 12 U.S.C. § 24(Seventh), the court distinguished this from the "business of the bank" referred to in the Farm Credit Act, which, in the court's view, included only "providing long-term real estate mortgage loans." REW, 49 F.3d at 166. Without explaining its reliance on the long-term/short-term credit distinction, the court stated that rural borrowers could seek LOCs from the Farm Credit System banks that were designed to accommodate short-term credit needs - that is, the BCs and PCAs. Id.

To the extent that a court might follow the reasoning set forth in REW in a case addressing the power of the FHLBanks to issue LOCs, there are important distinctions between the FLBs and the FHLBanks that would require a different result. Unlike the Farm Credit System (as it then existed), which comprised three different types of banks serving distinct functions, the FHLBank System comprises only the FHLBanks, which not only are expressly authorized to provide both long-term and short term advances, see 12 U.S.C. § 1430, 1430b, 1431 (g), but, as Congress has made clear on many occasions, also are authorized to serve the myriad credit and payment processing needs of their members,, See 108 Cong. Rec. H4994 (1989) (by broadening the FHLBanks' incidental powers, Congress intended to ensure that the FHLBanks "may provide a variety of products and services," thereby making "membership in the FHLBanks appealing to eligible institutions" and rendering the FHLBanks better able to "meet the financial obligations" imposed upon them); H.R. Rep. No. 842, 96th Cong., 2nd Sess. 74 (1980) (in broadening the FHLBanks' payment processing powers, Congress indicated that "it is important that the [FHL]Banks have the ability to service the broad and evolving financial service needs of members"). In addition, whereas the FLBs had absolutely no regulatory authorization to issue LOCs, the FHLBanks have been authorized by policy since 1983 to issue LOCs and will be authorized by regulation to do so if a final LOC rule is adopted by the Board of Directors of the Finance Board. For these reasons, the holding of the REW court regarding the FLBs is inapposite to the FHLBanks' authority to issue and confirm LOCs.

D. Settlement of a Member's Obligation Pursuant to a Standby LOC Transaction

Once a FHLBank issues a standby LOC, a number of scenarios are possible. In the most likely case, the member/applicant will fulfill all of the duties it is required to perform under its contract with the beneficiary and the LOC will expire without the occurrence of a draw thereunder. Less likely would be a scenario under which the beneficiary presents a conforming draft to the FHLBank pursuant to the LOC. In that event, the FHLBank would, be obliged to honor the draft and the member/applicant would be obliged immediately to make available to the FHLBank - through the member's deposit account or otherwise -- funds sufficient to reimburse the FHLBank for the amount of the draw. If that occurs, the member's obligation to the FHLBank would be satisfied and the transaction would be completed as the parties had intended.

It remains possible, however, that the member/applicant would fail to fulfill its obligation to reimburse the FHLBank for the payment it has made on a conforming LOC draft. In this case, the options available to the FHLBank to deal with the member/applicant's default would depend on the statutory source from which the FHLBanks' LOC authority is deemed to arise.

Under the payment processing theory, the disbursement of funds to the beneficiary of a LOC is authorized as the payment of a draft permissible under the FHLBanks' payment processing authority. In this case, the failure of the member/applicant to reimburse the FHLBank is considered to be an overdraft to the member's -deposit account at the FHLBank. The FHLBank would have three options for dealing with this overdraft. First, the FHLBank could exercise reasonable forbearance and allow its member additional time to make a full reimbursement, along with any penalties or other fees. Second, the FHLBank could immediately exercise its legal right to recover the amounts on which its member has defaulted, either by initiating proceedings to foreclose on the collateral, or by other appropriate methods. Finally, the FHLBank, at its discretion, could permit its member to finance its reimbursement obligation by drawing down an advance from the FHLBank.

The latter option, of course, could be pursued only if the member were able to comply with the statutory and regulatory advances requirements at the time the advance is drawn down. Among other things, this means that the member would need to: (1) qualify for an advance under the FHLBank's credit policy, see 12 C.F.R. § 935.5; (2) produce collateral eligible to secure advances under section 935.9(a) of the Advances Regulation, see id. § 935.9(a); (3) ensure that it owned sufficient FHLBank stock to be in compliance with the advances-to-stock ratio requirement of section 935.15(a) of the Advances Regulation, see id. § 935.15(a); and (4) if the advance is to be long-term (i.e., for more than five years, see id. § 935.1), or if the member is a non-QTL member, ensure that the advance is for a proper purpose.. See id. §§ 935.13 & .14.

E. Restrictions

Because FHLBank standby LOCs also may be authorized pursuant to section 11(e) of the Bank Act, or as a commitment to make an advance, most of the restrictions and limitations imposed by the Interim SLOC Policy, which are derived from the restrictions on advances, are not required by statute. Accordingly, the Finance Board has the authority to modify or dispense with any such limitations or restrictions that are keyed solely to a FHLBank's power to make advances, as opposed to the incidental power to commit to make advances.

1. Collateral

Regardless of the source of the authority to issue standby LOCs -- *i.e.*, the payment processing power or the incidental powers to enter into advance commitments -- a standby LOC need not, as a matter of law, be secured at the time of issuance by the same types of collateral that would be required for an advance. Section 11(e) imposes no security requirements upon the FHLBanks' payment processing activities. See 12 U.S.C. § 1431.(e). In addition, while section 10(a) provides that a FHLBank must obtain a security interest in certain specified types of "eligible collateral" upon the origination or renewal of an advance, there is no comparable requirement that a FHLBank must limit itself to such categories of "eligible collateral" on the date that it enters into a commitment to make an advance. See *id.* § 1430(a). Indeed, there is no requirement that a FHLBank must obtain a security interest in any collateral upon making a commitment to make an advance, although in the exercise of its safety and soundness oversight responsibilities the Finance Board could impose such a requirement. Because the issuance of a standby LOC does not constitute the origination or renewal of an advance, the Finance Board could authorize the FHLBanks to accept, at the time a LOC is issued, types of collateral other than those that are eligible to secure advances. Of course, if a member or nonmember mortgagee were to receive an advance to fund its reimbursement of a FHLBank for payments made under a LOC, all statutory and regulatory advances requirements would apply at that time.

Obviously, if a FHLBank wishes to permit its members to secure standby LOCs with collateral other than that eligible to secure advances, yet anticipates permitting the member to receive an advance to reimburse the FHLBank in the event that it must make payment under the LOC, the FHLBank must have in place sufficient documents, controls, and procedures to ensure that sufficient eligible collateral is available should the FHLBank be obliged to pay under the LOC. Although that may well present policy or supervisory concerns for the Finance Board to address, it does not affect the legal conclusion that a FHLBank must take a security interest in "eligible collateral" only at the time that it is disbursing funds under an advance. Accordingly, it is the view of OGC that the Finance Board may authorize a FHLBank to accept other high-quality collateral, such as secured or guaranteed small business loans, obligations of state or local governments, or "other real estate related collateral" in excess of the statutory limitation thereon, to secure outstanding LOCs. OGC has not been asked to consider, and expresses no judgment regarding, whether FHLBanks may issue unsecured LOCs, or LOCs that are less than fully secured.

2. Stock Purchase Requirement

Similarly, because the issuance of a standby LOC does not constitute the origination or renewal of an advance, a standby LOC need not be considered to be an outstanding advance for other statutory or regulatory purposes. Accordingly, under either legal theory, the value of a standby LOC need not be included in the computation of a member's advances-to-FHLBank capital stock ratio, described in section 10(c) of the Bank Act, 12 U.S.C. § 1430(c), and section 93515(a) of the Advances Regulation, 12 C.F.R. § 935.15(a).

3. Purpose - QTLs and Non-QTLs

Under both legal approaches, the limitations on the ability of non-QTL members to obtain advances would not apply. Thus, a FHLBank could be permitted to issue on behalf of any member, without regard to QTL status, a standby LOC of any term and for any purposes. A standby LOC issued to any member therefore could be used for housing finance purposes, such as to support the financing of targeted economic development projects, or for purposes other than housing finance, such as to provide its member with liquidity or other funding, or to assist its member with asset/liability management. If the authority of FHLBanks to engage in standby LOC transactions derives not only from their advances powers, but also from the FHLBanks' payment processing powers, it would be inappropriate to subject the exercise of the payment processing powers to statutory restrictions upon the exercise of the advances powers. Because the Bank Act imposes no subject matter restrictions upon FHLBanks' ability to act as drawee on drafts drawn on the account of a member institution, the Finance Board is required to limit the purposes for which a FHLBank may issue a standby LOC. See 12 U.S.C. § 1431(e). Therefore, under this theory, the FHLBank could be authorized, in conformity with the Bank Act, to issue a LOC of any term to any QTL or non-QTL member for any purpose.

If the authority of FHLBanks to issue standby LOCs is considered to arise from the FHLBanks' incidental power to enter into commitments to make advances, the purpose of any advance that may occur to finance the member/applicant's reimbursement obligation would be determined at the time it was made, using the criteria set forth in the Advances Regulation. See 12 C.F.R. § 935.13 & .14. In this case, while it may be logical to consider the purpose of the advance to be the purpose for which the LOC was issued, there is no legal reason to treat advances made to finance a member's obligation to reimburse a FHLBank for payment on a LOC differently than any other advances. Because, under this theory, the "purpose" of the LOC would be of no consequence to the legality of any resulting advance, a FHLBank could issue a LOC on behalf of any member, without regard to QTL status, for any purpose.

4. Treatment of Nonmember Mortgagees

Because the authority of FHLBanks to engage in standby LOC transactions on behalf of members arises from their payment processing authority, as well as from their authority to make and to commit to make advances, standby LOCs issued on behalf of members need not be subject to the statutory provisions that apply to outstanding advances. However, 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.¹⁷ As such, 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 a the deposit account of a nonmember, any Finance Board authorization permitting FHLBanks to issue standby LOCs on behalf pf nonmembers must be grounded entirely in the FHLBanks' powers to make advances to nonmember mortgagees and to enter into commitments to make such advances. Specifically, this means that a payment made by the FHLBank to a beneficiary under a LOC issued on behalf of a nonmember mortgagee must itself be treated as an advance (albeit one disbursed, at the request of the nonmember, to a third party) and not merely as an account overdraft that may be reimbursed with the proceeds of advance.

Because a FHLBank may not enter into a commitment to make an advance that it does not have legal authority to make, a FHLBank may not issue a LOC on behalf of a nonmember for a purpose for which it could not make an advance to 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, see id., the purpose for which a standby LOC is issued on behalf of a nonmember also must govern the type of collateral that the FHLBank may accept to secure the LOC. If payment is made on the LOC and the nonmember does not meet the credit requirements that it would normally be required to meet if it were taking down a regular advance, it must be considered immediately to be in default and the FHLBank must begin proceedings to foreclose upon the collateral that secured the LOC. Thus, FHLBank standby LOCs issued on behalf of nonmembers must continue to conform to the purpose and collateral requirements set forth in the nonmember mortgagee provisions of section 10b of the Bank Act..¹⁸

III. Conclusion

Under the Finance Board's Interim SLOC Policy, FHLBank standby LOCs are considered to be issued pursuant to the FHLBanks' statutory power to make advances and, therefore, are made subject to all of the statutory and regulatory restrictions and limitations that apply to outstanding advances. However, two additional provisions described herein separately authorize FHLBank participation in standby LOC transactions. First, FHLBank authority to engage in all aspects of a standby LOC transaction may be considered to be part of, and incidental to, the FHLBanks' deposit-taking and payment processing powers set forth in section

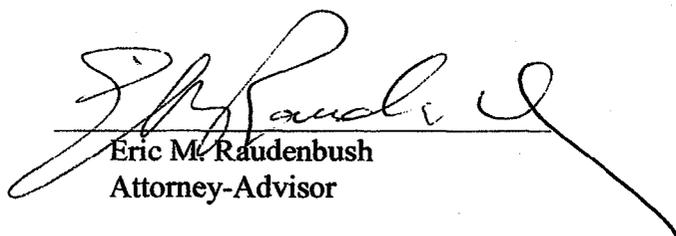
¹⁷ Technically, under section 11(e)(2), a nonmember mortgagee that qualifies to apply to become a member of a FHLBank could be eligible to benefit from the FHLBanks' payment processing powers and, therefore, also to obtain standby LOCs upon the same terms as member institutions. See 12 U.S.C. § 1431(e)(2). Reference to "nonmembers" herein presumes a nonmember that is not eligible to make application to become a FHLBank member.

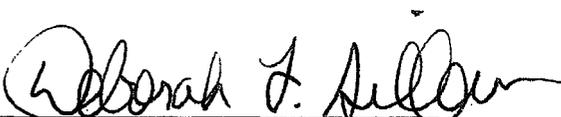
¹⁸ Nonmember mortgagees are neither required, nor permitted, to hold FHLBank capital stock at the time they receive an advance. See 12 U.S.C. §§ 1426, 1430b; 12 C.F.R. §§ 935.22-.24.

11(e) of the Bank Act. 12 U.S.C. § 1431(e). Second, while FHLBank authority to make payment to a third party beneficiary pursuant to a LOC draft must be considered to arise from the FHLBanks' payment processing powers, the authority of a FHLBank to issue a standby LOC alternatively may be considered to be part of the FHLBanks' incidental authority to enter into commitments to make advances.

Because neither of these legal approaches considers a standby LOC to be an outstanding advance, it is not necessary to make FHLBank LOCs subject to all of the statutory and regulatory restrictions and limitations that apply to outstanding advances. Accordingly: (1) a FHLBank standby LOC need not be secured only by collateral that is eligible to secure advances; (2) the value of a FHLBank standby LOC need not be included in the computation of a member's advances-to-FHLBank capital stock ratio; and (3) the FHLBank may be authorized, in conformity with the Bank Act, to issue a LOC of any term to any QTL or non-QTL member without restriction as to purpose.

Because the FHLBanks' express deposit taking and payment processing authorities do not apply to dealings with nonmembers and because the purposes for which FHLBanks may extend advances to nonmember mortgagees are tied by statute to the types of collateral accepted therefor, FHLBank standby LOCs issued on behalf of nonmember mortgagees must continue to conform to the purpose and collateral requirements set forth in the nonmember mortgagee provisions of section 10b of the Bank Act. 12 U.S.C. § 1430b.


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