



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

October 20, 1998

The Honorable Bruce Morrison
Chairman
Federal Housing Finance Board
1777 F Street, NW
Washington, D.C. 20006

Dear Mr. Chairman:

I am writing to express the Treasury's objections to the Federal Housing Finance Board's proposed rule expanding the Federal Home Loan Banks' (FHLBanks') authority to issue standby letters of credit. The proposed rule would enable the FHLBanks to make more aggressive use of their federal subsidy and to take on risks with which they have little or no experience. Yet it would not respond to any demonstrated market failure, would not advance the System's statutorily defined housing finance mission, and would rest on what we view as questionable legal authority.

Background

By obtaining a FHLBank standby letter of credit, a member institution can in effect borrow the FHLBank's credit rating -- derived in part from the FHLBank System's government sponsorship -- to obtain better terms in a financial transaction.

The Finance Board's Interim Policy Guidelines for FHLBank Standby Letters of Credit (the Interim Guidelines), which currently govern the FHLBanks' issuance of letters of credit, treat standby letters of credit as advances. Thus a FHLBank member obtaining a letter of credit from its FHLBank must post collateral and hold FHLBank stock against the letter of credit as if the letter of credit were an advance.

The Interim Guidelines specifically limit the purposes for which FHLBanks can issue standby letters of credit. Permissible purposes include facilitating the following types of transactions: the purchase of, or commitment to purchase, mortgage loans; the collateralization of public unit deposits; interest rate swaps and other transactions that assist a members' asset/liability management; and transactions that promote home financing, housing activity, or members' involvement in commercial and economic development activities that benefit low- and moderate-income neighborhoods.

While not all of these permissible uses necessarily advance the System's public purpose, the Interim Guidelines have the virtue of clearly enumerating the permissible uses of standby letters of credit, and thus tending to constrain unwarranted expansion of the FHLBanks' letter of credit activities. By requiring the FHLBanks to treat standby letters of credit as advances, the Interim Guidelines at least require such instruments to meet the safety and soundness standards applicable to advances.

The proposed rule, however, would eliminate the current treatment of standby letters of credit as advances, and thus would make many of those safety and soundness safeguards inapplicable. The proposed rule would also replace the specific list of permissible uses for standby letters of credit with a blanket authorization for the FHLBanks to issue letters of credit for any of four broad purposes: facilitating residential housing finance or other housing activity; facilitating the financing of targeted economic development projects; assisting members with asset/liability management; or "provid[ing] members with liquidity or other funding."

Reasons for Objection

We object to the proposed rule because: (1) the Finance Board has failed to show that expanding the FHLBanks' authority to issue standby letters of credit is necessary to overcome a market failure; (2) the four broad proposed purposes would not sufficiently link the FHLBanks' issuance of letters of credit to the System's housing finance mission; (3) the proposed rule raises safety and soundness concerns; and (4) the proposed rule rests on questionable legal foundation.

1. Not Necessary to Overcome Any Demonstrated Market Failure

The Finance Board has failed to show that expanding the FHLBanks' authority to issue standby letters of credit is necessary to overcome a market failure. The market for third-party credit enhancements, including standby letters of credit, is highly competitive. Many private financial institutions offer such credit enhancements. The proposed rule would permit the government-subsidized FHLBanks to compete directly with those private sector firms. Yet the Finance Board has failed to identify any failure in that market -- much less to demonstrate that expanding the FHLBanks' letter of credit activities is actually necessary to overcome such a market failure. In short, the proposed rule would appear to involve a needless expansion of government-subsidized competition with private providers of credit enhancements.

The notice of proposed rulemaking asks whether the Finance Board should impose a "private sector adjustment factor" on some FHLBank letters of credit to offset the advantages of the FHLBanks' government sponsorship. This question highlights what we view as a fundamental misreading of the role of a government-sponsored enterprise (GSE) and its regulator. The purpose of a GSE is to use a federal subsidy to advance a public purpose where the market has failed. One of the main purposes of GSE regulation is to keep the GSE focused on that public purpose. We do not believe that a GSE should enter businesses that do not advance its mission, even if it takes steps to counteract the effects of a federal subsidy.

2. Not Adequately Linked to System's Mission

The four proposed general purposes for which FHLBanks could issue standby letters of credit would not sufficiently link that activity to the System's housing finance mission. The breadth of the proposed purposes would allow the FHLBanks to finance -- with government subsidized funds -- a wide array of economic activities and other transactions that may have little or no relation to the System's mission.

For example, a FHLBank could use the fourth proposed purpose ("provid[ing] members with liquidity or other funding") to justify virtually any conceivable standby letter of credit transaction. Almost by definition, a standby letter of credit provides "funding," broadly construed.¹ Yet members could use a standby letters of credit for a very broad range of purposes -- purposes broader than those permissible for advances -- thus further attenuating any links to the System's mission. Likewise, a FHLBank could use the third proposed purpose ("assist[ing] members with asset/liability management") to conduct an extraordinarily broad range of transactions.

Moreover, the proposed rule would essentially delegate to the FHLBanks the initial decision on whether a given transaction would qualify. According to the notice of proposed rulemaking, "Under the proposed regulation, FHLBanks would determine, subject to Finance Board review and oversight, whether particular transactions fall within any of the [four broad] categories."² Leaving each of the twelve FHLBanks free to take a broad view of its standby letter of credit authority -- subject only to the possibility of

¹ *The New Palgrave Dictionary of Money and Finance* (1992) notes that "There have been a number of theories suggested to explain the growth in [standby letters of credit], all of which view [standby letters of credit] as a potential substitute for bank loans" (p. 530).

² 63 *Federal Register* 25,726, 25,727 (May 8, 1998).

subsequent regulatory criticism -- would create a strong bias toward expansive interpretation of the four already broad purposes.

3. Safety and Soundness Concerns

The proposed rule raises safety and soundness concerns. It would allow member institutions to secure letters of credit using collateral that would be unacceptable for advances: e.g., secured small business loans, or obligations of state or local government agencies. It would also allow members to use commercial real estate loans and other real estate loans as collateral without regard to the 30-percent-of-capital limit on the use of such assets as collateral for advances. By allowing the FHLBanks to accept as collateral assets that may be of lower credit quality than collateral traditionally accepted for FHLBank advances -- assets with which the FHLBanks have little or no experience -- the proposed rule would tend to increase the FHLBanks' risk profile and raise safety and soundness concerns. Broadening eligible collateral beyond housing assets would also erode any nexus between the FHLBanks' letter of credit activities and the System's housing finance mission.

Even as it would expose the FHLBanks to additional credit risk, the proposed rule would not require FHLBank members to allocate part of their FHLBank stock against that risk. On the contrary, the rule would abrogate the current requirement that a member institution hold FHLBank stock to support any letter of credit issued on the member's behalf. Thus the rule would in effect exempt standby letters of credit from all FHLBank capital requirements. Such a change would be economically unrealistic and adverse to the System's safety and soundness.³

The proposed rule could also create incentives for FHLBank members to use standby letters of credit in place of advances. This would further undermine safety and soundness -- since the rule would apply much looser safeguards to standby letters of credit than to advances.

4. Questionable Legal Foundation

The Finance Board's legal justification for the proposed rule is dubious, we believe, and differs significantly from that underlying the Interim Guidelines. The Interim Guidelines

³ The risk-based capital rules for FDIC-insured depository institutions treat standby letters of credit as having the same credit risk as direct lending assigning them to the same 100 percent risk-weight as a typical commercial loan. 12 C.F.R. part 3, appendix A, §3(b).

viewed a standby letter of credit as the functional equivalent of an advance. Such a view reflects economic reality: a letter of credit subjects the obligor to the same type of credit risk as a loan.

The proposed rule rests on a very different approach, which the notice of proposed rulemaking summarizes as follows:

"The Finance Board . . . 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 [that underlying the Interim Guidelines], but also may be considered to be part of, and incidental to, the FHLBanks' deposit-taking and payment processing powers

"The Finance Board also has determined that the authority of a FHLBank to issue a standby LOC may be considered . . . 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 . . . 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."⁴

We note at the outset that neither here nor elsewhere in the notice of proposed rulemaking does the Finance Board provide a rigorous legal justification for the proposed rule. Instead, the quoted passage simply recites that the Finance Board "undertook a review" of the legal issues and then states the Finance Board's conclusions.

We find those conclusions implausible on their face. Unlike a standby letter of credit, deposit-taking by a FHLBank involves no extension of credit by the FHLBank. On the contrary, such deposit-taking constitutes borrowing by the FHLBank from its member-depositors -- the very opposite of an extension of credit.

Payment processing is likewise quite different from lending. Of course, a standby letter of credit may give rise to a payment, and payment processors may provide lines of credit to cover overdrafts or the like. But to assert that standby letters of credit are "part of, and incidental to, the FHLBanks' . . . payment processing" is to have the tail wag the dog. It is akin to saying that insurance underwriting is part of and incidental to claims processing -- or even check clearing.

⁴ 63 *Federal Register* at 25,727.

Nor is it credible to characterize standby letters of credit as "part of the FHLBanks' incidental authority to enter into commitments to make advances." A standby letter of credit serves as a direct substitute for an advance. The proposed rule would make letters of credit competitors of, rather than incidental to, advances. To label a standby letter of credit "incidental" to advances (while exempting it from the safeguards applicable to advances) is plainly illogical.

Conclusion

If the Finance Board wishes to pursue the question of expanding the FHLBanks' authority to issue standby letters of credit, we urge that it: (1) ascertain whether there is a failure in the market for third-party credit enhancements; (2) ascertain whether any proposed expansion of the FHLBanks' authority is necessary to overcome that market failure; (3) rigorously link any such proposed expansion to the FHLBank System's statutory mission; (4) provide a closely reasoned legal justification for any such expansion; and (5) assure that any such expansion would not adversely affect the System's safety and soundness.

Sincerely,



Richard S. Carnell
Assistant Secretary for Financial Institutions

cc: The Honorable J. Timothy O'Neill
Mr. Art Agnos