

**Amending Section 149:
Allowing Community Banks to use
FHLBank Standby Letters of
Credit (SLOCs) to Serve their
Communities**



Profile of the FHLB System

- Approximately 8,100 financial institutions from all 50 states are members of the FHLB System
- FHLBanks provide low-cost liquidity and financial products to their members
- The only capital market access for the vast majority of banks in this country
- Each FHLBank is managed independently and is regulated by the Federal Housing Finance Board
- Credit ratings of each FHLBank are based on its financial strength



FHLBank SLOC Authority

- FHLBanks have issued SLOCs since 1983
- FHLBank SLOC authority expanded with FIRREA in 1989 to include community and economic development
- FHLBank SLOCs are expressly authorized by Finance Board Regulation



Current FHLBank SLOC Activity Supporting FHLBank Members

- \$20 billion in SLOCs outstanding as of 12/31/06
 - Approximately 2% of FHLBanks' total combined assets
- Examples of uses of FHLBanks' SLOCs today include:
 - To secure members' public (state and local government) deposits
 - To confirm their members' credit enhancement of certain tax-exempt housing bonds
 - To confirm their members' credit enhancement of taxable bonds



Proposed Legislation

- The proposed change to I.R.C. Sec. 149(b) will allow the FHLBanks to confirm members' Letters of Credit (LOCs) that back non-housing tax-exempt bonds
- Examples of such bonds include:
 - Qualified small issue bonds, supporting industrial development
 - Qualified 501(c)(3) bonds, supporting things such as health care facilities and small colleges and universities
- Joint Tax staff scored at \$6 million over 5 years

GSE Guarantees are Already Permitted

- The Tax Code permits the authorized activities of certain federal and federally related entities to support tax-exempt bond issue structures.
- Exempt from 149 are:
 - Fannie Mae
 - Freddie Mac
 - GNMA
 - FHA
 - VA

Underserved Markets FHLBank SLOCs Could Support

- Bond issues requiring credit enhancement underwriting beyond the municipality's or issuer's credit – those that are project-based
- Underwriting these types of credits is the very nature of community banking
- Data show bond insurers are not as active in small dollar transactions (less than \$10 million)
- Unrated issuers face limited access to debt market without credit enhancement

Underserved Markets (Cont'd.)

- Smaller municipalities and governmental units seeking choice in bond structure (fixed vs. variable) and credit enhancement fee structure:
 - May reduce costs for these governmental units
 - LOC fee structure offers an alternative to bond insurance
- Small issues and unrated issuers requiring credit enhancement for:
 - Housing
 - Education
 - Health Care
 - Cultural facilities
 - Infrastructure/economic development

Underserved Market Examples

FHLBank/Community Bank partnerships could provide credit support for:

- Marion College, Wisconsin (\$3M issue)
- Bear Lake Memorial Hospital, Montpelier, Idaho (\$3.2M issue)
- Several small manufacturing projects throughout WVA, per the WVA Economic Development Authority

Size of Market for FHLBank SLOCs

- Foreign and money center banks will continue to dominate the market for large private activity LOC deals
- Bond insurers will dominate the market for municipal government non-project based deals
- FHLBank SLOCs will likely be focused on smaller commercial lending-like private activity transactions

FHLBank SLOCs will Serve Different Markets

- FHLBank SLOCs for taxable bonds currently co-exist with bond insurance
- Bond insurance is better suited for larger investment-grade (or better) rated issuers
 - Some smaller issuers and unrated issuers are not served effectively by bond insurers
- FHLBank SLOCs will allow *community banks* to better serve the needs of their communities
 - Community banks do not participate in the credit enhancement market for large municipal tax-exempt bonds
 - Limited area of overlap between bond insurers and community banks

Benefits of New Authority

- Offers community banks another way to support economic development in their communities
- Community banks can offer borrowers, their customers and their communities more flexibility
 - Either issue LOC or purchase tax-exempt bonds
 - LOC may offer better allocation of risks between community bank (credit) and capital markets (interest rate)

No New Risks

- FHLBanks have significant experience in lending to community banks
 - Confirming SLOC is fully collateralized
 - FHLBank is not taking on risk of the project
- Community banks have significant experience in commercial lending
 - Know their communities' needs and can effectively assess the viability of projects
 - Strong underwriting competencies
 - Safety and soundness standards and lending limits would apply to community banks' LOC activities

The Legislation helps Small Banks

- Technology, economies of scale, and other factors lead to dominance by large financial services providers.
- Federal policy makers often try to ensure that community banks can remain the lifeblood of their communities – able to offer the broad range of financial services.
- This legislation will enable community banks to offer services currently provided by the larger financial companies.

Enables the Member-FHLBank Business Model to Help Communities

- FHLBank members are expert at underwriting risk and extending credit to a wide range of borrowers.
- FHLBank members are subject to statutes that require them to support their communities through the Community Reinvestment Act.
- FHLBanks' operating statute requires we support community and economic development.
- The legislation can help reduce local government costs and increase the available funds for important community and economic development.

Conclusions

- This legislation will enable community banks to offer services in a market that's not the focus of the large bond insurers.
- Our view is there will not be much overlap between FHLBank SLOCs and bond insurer backed tax-exempt deals.
- It will neither cost the federal government very much nor expose it to new risk.
- It will allow community banks to apply their expertise in underwriting local credits in a sound partnership with FHLBanks, much the way they have for 75 years.