GOVERNMENT BANKING
and the use of
FEDERAL HOME LOAN BANK LETTERS OF CREDIT
to secure public deposits
FAQs for Customers

This method of protecting deposit balances relies upon the creditworthiness of the Federal Home Loan Bank, a triple A rated credit, to pay to the customer the value of the customer's deposits up to the value of the LOC if a bank were to be unable to administer or pay against the customer's accounts and balances. The LOC will protect the customer's balances either on an individual account basis or on a relationship basis. To assist customers in understanding the use of letters of credit to secure their deposits, the following questions and responses are included, as is a history of the federal home loan bank system taken from its website http://www.fhlbanks.com/ where further details can be found.

What is a Federal Home Loan Bank?

The Federal Home Loan Banks are government-sponsored enterprises, federally chartered but privately capitalized and independently managed.

Each Federal Home Loan Bank is governed by a board of directors made up of industry directors elected by member institutions and public-interest directors appointed by the System's federal regulator, the Federal Housing Finance Board.

Each Federal Home Loan Bank is capitalized by the capital-stock investments of its members and its retained earnings. Members purchase stock in proportion to their borrowings from the Federal Home Loan Bank, their holdings of mortgages and mortgage securities, and their assets.

The Federal Home Loan Banks meet all their costs from earnings, including the costs of raising funds jointly in the capital markets. In addition, they are assessed for the full costs of the Finance Board. No tax dollars are involved in the operation of the Federal Home Loan Bank System. The Federal Home Loan Bank System raises funds by issuing debt instruments (bonds and notes) in the capital markets. Because these instruments have "AAA" credit ratings, the Federal Home Loan Bank System can borrow at very favorable rates and terms. However, Federal Home Loan Bank debt is not guaranteed by, nor is it the obligation of, the U.S. government.

[Federal Home Loan Banks are located in Atlanta, Boston, Chicago, Cincinnati, Dallas, Des Moines, Indianapolis, New York, Pittsburgh, San Francisco, Seattle, and Topeka.]

Source: http://www.fhlbanks.com/html/history.html

How does the letter of credit function to secure deposits?

If the customer agrees to the use of the LOC, the Government Banking Officer or the Relationship Manager and the customer will determine the estimated level of deposits at any one time during a 12 month period. The officer will make a request to the bank's Treasury Department for the issuance of an LOC for the customer and for the agreed upon amount. The officer will advise Treasury of the start and end dates for the LOC. The Treasury Department will make the application to FHLB for the issuance of the LOC and the FHLB will prepare the formal LOC and deliver it to the Treasury Department within 3 -5 business days. The Treasury Department will copy and log in the LOC and then deliver it to the customers. That LOC is proof of coverage and the customer should protect the document as it would any other financial document.

In the event that a bank defaults and the customer could not receive its funds from the bank, the customer would prepare and deliver to FHLB the sight draft and a letter of request to draw funds against the LOC. If the sight draft and the letter of request are received by 11:00 a.m. in Pittsburgh, the funds will be disbursed by wire transfer on the same day, if they received after 11:00 a.m. the funds will be wired the next business day. If the sight draft does not contain routing and account information, the FHLB will mail a check payable to the customer. The original sight draft and the letter of request must be received by the FHLB, and can be sent by US mail or overnight delivery.

How much can the customer draw against the LOC?

The customer can draw the full amount of the LOC up to the amount of its deposits that are not otherwise secured through insurance (FDIC or private insurance) or collateralized with other securities (third-party custodian accounts, joint custody accounts, and overnight or term repurchase agreements).

Can a bank unilaterally cancel the LOC once the LOC is issued?

No, the LOC is an irrevocable stand-by letter of credit. It can not be terminated without agreement of the customer. Therefore, the bank can not unilaterally cancel the LOC.

Can a bank unilaterally change the amount of coverage either increasing or decreasing the amount of coverage?

No, the LOC is an irrevocable stand-by letter of credit. It can not be changed without agreement of the customer. Therefore, the bank can not unilaterally reduce the Maximum Credit Amount of the LOC.

In the event of a needed increase, the bank would apply for a new LOC to layer with the current LOC for full coverage.

In the event of a temporary increase in the Maximum Credit Amount the bank will request a second limited duration LOC. The Maximum Credit Amounts of the primary and secondary LOCs would be combined to determine the customer's Maximum Credit Amount.

When would LOC protection be effective, on the date of request to the bank by an officer; on the date of request by a bank's Treasury Department to the FHLB; or, on the LOC's date of issue by the FHLB?

The customer's deposits would be protected as of the date the LOC is issued by the FHLB. Therefore, it would be prudent to have the LOC in place before having the customer deposit into their account if they have concerns about a short period of non-coverage. Also, the bank. requests the release of collateral from joint-custody or third-party custodian accounts, the release will not be submitted to the custodian until the LOC is in place.

How does the use of LOCs benefit the customer?

Enhanced coverage

By using the LOC, the customer will have its full deposit relationship protected up to the Maximum Credit Amount rather than individual accounts as is the case for insured or repurchase agreement products. LOCs can be issued for individual accounts in which case the individual account would be protected up to the Maximum Credit Amount.

Customers who use LOCs will not have to be concerned with the changing market value of government securities that are held in third-party custodian or joint-custody accounts.

Reduced paperwork

Customers who use LOCs will have less paper, less reporting and less reconciliation. The customer will receive the LOC and know the coverage limit. If their balances are growing, temporary increases can be put in place relatively quickly.

Currently customers receive monthly statements from the third-party custodians, or monthly e-mailed statement or quarterly paper statement for joint-custody accounts. For customers in collateralized repurchase agreements, they receive daily faxes confirming the assignment of collateral. Finally, customers in insured products receive a separate certificate of insurance for each insured account.

Fast payout in the event of a bank default

In the event that the bank defaults, the customer will send the sight draft and the letter of request to the FHLB for payment.

Full balance protection up to the Maximum Credit Amount

The LOC is in place for the full term of the LOC. Certain customers and auditors have expressed concerned that overnight repurchase agreements are released at the start of the business day thereby placing the customer's funds at risk during daylight hours. The LOC addresses that concern because it is in place morning, noon and night. While we do not see that there is a daylight exposure, this concern has been raised by several auditors.

How would deposits secured through a letter of credit issued by the Federal Home Loan Bank be categorized under GASB standards for audit and financial statement reporting?

Pursuant to the Comprehensive Implementation Guide-2004, issued by the Governmental Accounting Standards Board (Question 1.96), an irrevocable letter of credit can be considered a form of insurance if the bank or the bank's affiliate did not issue it and provides a scope of coverage substantially the same as that provided by federal deposit insurance. Thus the irrevocable standby letter of credit issued by the Federal Home Loan Bank is not exposed to custodial credit risk, and deposits should be considered category 1…

Letter of Opinion, Runyon, Kersteen Ouellette, CPAs and Business Consultants, March 14, 2006