

Federal Home Loan Banks letters of credit for tax-exempt bonds

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Current difficulties in the municipal bond market, including ratings downgrades for municipal bond insurers, have made new bond issuances for many cities nearly impossible. In response, the National League of Cities is seeking market reforms in the upcoming economic stimulus package that will help state and local governments have better access to the capital markets and the municipal securities market.

However, local governments can take advantage of another market reform supported by NLC that passed on July 30 as part of the Housing and Economic Recovery Act (PL110-289).

Among other things, this act permits Federal Home Loan Banks (FHLBanks) to issue letters of credit (LOCs) to guarantee tax-exempt municipal bonds for a wide range of projects *through December 31, 2010*.

Prior to the new law, the FHLBanks were restricted to guaranteeing tax-exempt bonds only for multi-family housing projects. Under the new law, FHLBank LOCs can be used to support tax-exempt municipal bond issuances for any economic development project without jeopardizing the tax-exempt status of the bonds.

Any entity permitted to issue tax-exempt bonds, including municipalities, can use FHLBank LOCs. Eligible projects include economic development, public safety, small manufacturing, water and sewer, nonprofit hospitals and other health care facilities, colleges and universities, and local infrastructure.

A small number of FHLBank LOC transactions have been completed already, including two that are providing for the expansion of a label factory in an economically depressed area of California and for improvements to a retirement community in Indiana.

One caveat of the new law, however, is that *cities only have until December 31, 2010*, to take advantage of the new Letter of Credit authority. Congress must renew the law at that time or allow it to expire. In addition, the FHLBanks can only provide LOCs to bonds issued after July 30, 2008, when the law was enacted. Any issuer wanting a letter of credit for an existing bond would only be able to obtain one through a refunding.

How a FHLB letter of credit works

The FHLBanks wrap the tax-exempt debt with their AAA- or AA-rated LC and take a second-loss position behind the member institution.

A FHLBank member financial institution works with bond underwriters to determine project feasibility and assume the first-loss position on the debt.

The issuer issues the bond with an AAA or AA credit rating and benefits from lower cost of funds and increased marketability.

The investors are insulated from risks associated with potential inability of the municipality to pay interest and principal on the bond. The investor also benefits from reduced price volatility associated with bond downgrades.

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The Federal Home Loan Banking System is a cooperative of 12 independent regional Federal Home Loan Banks created by Congress in 1932. These banks provide liquidity to support housing finance and community lending for more than 8,000 local financial institutions, including commercial banks, savings institutions, credit unions, and insurance companies.

The 12 FHLBanks are currently reaching out to municipalities and other issuers to promote the new credit enhancement authority. Several FHLBanks are also offering complimentary presentations and seminars on Letters of Credit. To learn about LOC presentations, or to discuss whether an FHLBank LOC could work for a specific project, please contact Steve Otto, Dallas, TX, steve.otto@fhlb.com, (214) 441-8711.