

FHLBank Issue Brief

Letters of Credit

Federal Home Loan Bank letters of credit (LOCs) are a valuable tool that members can use to support local communities across the country, allowing them to leverage the credit strength of their FHLBank for public good. An LOC is a credit enhancement tool that helps members reduce risk and lower borrowing costs. LOCs represent a promise, made at the request of an FHLBank member, to ensure payment to a third-party beneficiary if the member is unable to fulfill its obligations.

How LOCs Work

- Member requests a letter of credit from its FHLBank.
- The member pledges collateral to the FHLBank to support the LOC.
- FHLBank issues the LOC on the member's behalf to a beneficiary (e.g., state treasury, municipal government).
- The LOC guarantees the obligation, backed by the FHLBank's credit strength.

FHLBank members use LOCs to support public unit deposits (PUDs), provide credit enhancement for certain transactions, and to support payment obligations to third parties.

LOCs are secured by collateral such as single-family mortgage loans and mortgage-backed securities and are offered with a variety of terms. Most LOCs are short term, expiring within one year, but LOCs can be renewed and extend out as long as 15 years. This flexibility helps members effectively manage their liquidity needs and support housing and community development.

As of year-end 2024, the Federal Home Loan Bank System had approximately \$220 billion in outstanding letters of credit, reflecting their widespread use as a credit-enhancement and liquidity tool in communities across the country.

Cost Savings

FHLBank LOCs allow communities and public-purpose entities to borrow as if they had the FHLBank's credit strength, not their own, turning credit quality into immediate savings.

When a municipality or public entity issues debt without an FHLBank LOC, investors typically require some level of credit protection – usually cash or high-quality securities – as a guarantee of payment. With an FHLBank LOC, the LOC is itself the credit protection, reflecting the FHLBank's creditworthiness. This materially lowers borrowing rates by broadening the appeal of the entity's obligations to a wider pool of investors, increasing competition for those obligations and tightening investor spread demands. Additionally, the entity issuing the debt can keep its cash or securities on its balance sheet where it can continue to earn yield.

Members that request an LOC are commonly charged a combination of an upfront and period fee for LOC commitments. Pricing varies based on the amount requested and the maturity period. As with FHLBank advances, LOCs are fully collateralized, typically with single-family mortgages, multifamily or commercial real estate loans, or other eligible assets pledged by the member.

Common LOC Uses

FHLBank members use LOCs for a range of purposes, including to attract and retain PUDs, support municipal financing and revenue bond financing for housing and infrastructure projects, and lower borrowing costs for community development activities.

PUDs allow FHLBank members of any size to attract deposits that are higher than FDIC insurance limits. State laws typically require financial institutions to collateralize deposits above the FDIC cap, and PUD eligibility often hinges on whether FHLBank letters of credit are permitted as acceptable collateral. Where allowed, FHLBank LOCs help members meet statutory collateral requirements, avoiding the need to pledge U.S. Treasuries or other comparably safe assets.

Example: Infrastructure Project

- Local city aims to build a new \$35 million fire station to serve a growing neighborhood and will issue short-term bonds to support the project.
- City works with a local lender (FHLBank member) to secure a \$35 million LOC.
- Investors rely on the FHLBank's creditworthiness (not just the city's balance sheet) to guarantee payment.
- Demand for bonds increases and bond prices are reduced.

Example: PUDs

- Local city deposits \$5 million at a local lender (FHLBank member).
- FDIC insurance applies to first \$250,000.
- Local lender obtains FHLBank LOC for the excess balance (\$4.75 million).
- LOC is issued and local city is named as beneficiary of the LOC.
- If local lender fails, FDIC handles the insured portion (\$250,000) and the FHLBank LOC covers the remainder.

Default

If an FHLBank is required to make payment under a letter of credit, the member either reimburses the FHLBank for the amount or, subject to the applicable FHLBank's discretion, the pledged collateral is used to repay the LOC, or the LOC is converted to a collateralized advance to the member.

