

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Parts 545, 560

[No. 98-92]

RIN 1550-AB21

Letters of Credit, Suretyship and Guaranty

AGENCY: Office of Thrift Supervision, Treasury.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Office of Thrift Supervision (OTS) is proposing to amend its regulations to clarify that a Federal savings association may act as guarantor and may issue letters of credit. Additionally, the proposed rule would impose restrictions, based on safety and soundness, on suretyship and guaranty agreements issued by Federal and state-chartered savings associations. The OTS is also requesting comment on whether it should adopt a regulation addressing the escrow authority of Federal savings associations.

DATES: Comments must be received on or before [Insert 60 days from date of publication in the Federal Register].

ADDRESSES: Send comments to Manager, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552, Attention Docket No. 98-92. These submissions may be hand-delivered to 1700 G Street, N.W., from 9:00 a.m. to 5:00 p.m. on business days; they may be sent by facsimile transmission to FAX Number (202) 906-7755; or they may be sent by e-mail: public.info@ots.treas.gov. Those commenting by e-mail

should include their name and telephone number. Comments will be available for inspection at 1700 G Street, N.W., from 9:00 a.m. until 4:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT: William J. Magrini, Senior Project Manager, (202) 906-5744, Supervision Policy; Raynette Gutrick, Attorney, (202) 906-6265, Regulations and Legislation Division or Karen Osterloh, Assistant Chief Counsel, (202) 906-6639, Regulations and Legislation Division, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION:

The OTS is proposing this rule to clarify a Federal savings association's authority to act as guarantor and to issue letters of credit. Additionally, the proposed rule would impose restrictions, based on safety and soundness, on suretyships and guaranty agreements issued by Federal and state-chartered savings associations. The OTS also is seeking comment on whether it should adopt a regulation to address the escrow authority of Federal savings associations.

I. Suretyship and guaranty

Section 5(b)(2) of the Home Owners' Loan Act (the "HOLA") provides "[t]o such extent as the Director may authorize in writing, a Federal savings association . . . may be surety as defined by the Director"¹ The OTS's current regulations at 12 CFR 545.103 authorize Federal savings associations to act as surety

¹ 12 U.S.C.A. 1464(b)(2) (West 1998).

subject to several requirements.

The OTS is proposing to make several modifications to the surety regulation. Initially, the OTS would move this regulation from part 545, which governs the general operations of Federal savings associations, to Part 560, subpart A, which addresses the lending and investment powers of Federal thrifts. See proposed § 560.45.

Neither HOLA nor the current OTS regulations specifically address a Federal savings association's authority to issue a guaranty. Under a suretyship agreement, the surety is bound with its principal to pay or perform an obligation to a third party.² Under a guaranty agreement, on the other hand, the guarantor agrees to satisfy the obligation of the principal to another only if the principal fails to pay or perform.³ While both a surety and guarantor agree to be bound for the principal, there are other differences between the two types of agreements. A surety is usually bound with the principal by the same instrument, which is executed simultaneously.⁴ On the other hand, a guarantor usually enters into a separate agreement with the third party in which the principal does not join.⁵ The guaranty agreement is usually entered into before or

² BLACK'S LAW DICTIONARY 1441-42 (6th ed. 1990).

³ Id. at 705.

⁴ Id. at 1441-42.

⁵ Id.

after that of the principal, and is often founded on a separate consideration from that supporting the contract of the principal.⁶

The OTS and its predecessor, the Federal Home Loan Bank Board (“FHLBB”), have long recognized that the authority of a Federal savings association to act as guarantor is subsumed within section 5(b)(2) of the HOLA.⁷ To clarify this point, proposed § 560.45 would specifically state that a Federal savings association is also authorized to act as guarantor.

Currently, § 545.103 contains various provisions designed to ensure the safety and soundness of surety agreements by Federal savings associations. These safety and soundness concerns are the same for suretyship and guaranty agreements by state-chartered savings associations. Accordingly, the OTS proposes to incorporate these requirements in part 560, subpart B, which contains the safety and soundness-based lending and investment restrictions applicable to all savings associations. Proposed § 560.115(a) would state that to the extent that a savings association has the legal

⁶ Id. Suretyship and guaranty agreements are similar to letters of credit to the extent that they are used for a common purpose—ensuring against the obligor’s nonperformance. Under a letter of credit, however, the savings association’s obligation to honor depends on the presentation of specified documents and not upon non-documentary conditions or resolutions of questions of law or fact at issue between the account party and the beneficiary. See 12 CFR 560.120(a) (1998).

⁷ See e.g., 48 FR 23032, 23043 (May 23, 1983) (stating that section 5(b)(2) of the HOLA empowers the FHLBB to authorize by regulation the issuance of suretyship devices by Federal savings associations for the purpose of guaranteeing the obligations of others); FHLBB Op. Assoc. Gen Counsel (July 5, 1983) (permitting the association to act as surety or guarantor under section 5(b)(2) of the HOLA). See also 12 CFR 545.16(a)(3) (1998) (“surety” means surety under real and/or personal suretyship, and includes guarantor).

authority to do so, it may enter into an agreement to act as surety or guarantor, if the agreement meets stated requirements. Proposed section 560.115(b) is a new provision, which explains the terms “suretyship and guaranty agreement.”

Proposed § 560.115(c) would contain four restrictions on surety and guaranty agreements. The first restriction is new. It would require that the association’s obligation under the suretyship or guaranty agreement be limited to a fixed amount and limited in duration. Without a restriction limiting the amount and duration of the agreement, a Federal savings association may take on more risk than it bargained for in the agreement. The remaining three restrictions are based on the current rule on suretyship agreements at § 545.103. Under the proposed rule, a savings association may enter into an agreement only if its performance under the agreement (e.g., the payment of the obligation on behalf of the principal) would create a loan or other investment that is authorized for the association under applicable law. Additionally, the savings association’s obligation under the agreement would be treated as a contractual commitment to advance funds to the principal under the loans-to-one-borrower limits and loans to insider restrictions. Finally, the savings association must take and maintain a perfected security interest in collateral sufficient to cover its obligation under the agreement.

The proposed rule would modify the collateral requirements currently imposed under existing § 545.103. Under the current rule, a Federal savings association must take and maintain a security interest in real estate or marketable securities equal to 110 percent of its obligation under the agreement.⁸ If the collateral is real estate, the Federal savings association must establish the value of the property by a signed appraisal consistent with 12 CFR part 564. If the collateral is marketable securities, the Federal savings association must be authorized to invest in the securities and must ensure that the value of the securities is equal to 110 percent of the obligation at all times. These requirements are retained for all savings associations at proposed § 560.45(d)(1).

The proposed rule, however, would permit a savings association to hold collateral of a lesser amount under certain circumstances. This new provision is modeled on the Office of Comptroller of the Currency's (OCC) rule on suretyship and guaranty agreements.⁹ Under proposed § 560.45(d)(2), a savings association would be permitted to maintain a security interest equal to 100 percent of the obligation, if the collateral is cash, obligations of the United States or its agencies, obligations fully guaranteed by the United States or its agencies as to principal and interest, or notes, drafts, or bills of exchange or bankers' acceptances that are eligible for rediscount or

⁸ 12 CFR 545.103(b) (1998).

⁹ 12 CFR 7.1017 (1998).

purchase by a Federal Reserve Bank.¹⁰

The OTS requests comment on whether there are other suretyship, guaranty, or similar arrangements that the OTS should permit either by rule or through an approval process. For example, the OCC has determined that an arrangement whereby a national bank holds out to the public that it will honor checks drawn on it up to a certain amount, is essentially an agreement by the bank to extend credit to the depositor and is a permissible activity.¹¹ The OTS requests comment on whether the final rule should clarify how it will treat such arrangements.

II. Letters of credit and other independent undertakings

Under existing OTS and FHLBB precedent, Federal savings associations are authorized to issue letters of credit. Although the HOLA does not explicitly confer the authority to issue letters of credit, both agencies determined that the express authority to invest in or make loans necessarily includes the authority to make loan commitments and to issue letters of credit.¹²

¹⁰ Certain provisions of existing § 545.103 have not been retained. For example, current § 545.103(c) addresses what happens if a Federal savings association is required to perform under the suretyship agreement. This section states that a Federal savings association would be required to treat the amount advanced as an extension of credit, subject to investment limits and other restrictions applicable to such an extension of credit. The OTS has not retained this paragraph because it duplicates existing § 560.31(a).

¹¹ See 12 CFR 7.7015 (1996).

¹² 61 FR 50951, 50958 (September 30, 1996). This authority was first recognized in 1983 by the FHLBB, which determined that this power was implicit under new lending authority in the Garn-St.Germain Depository Institutions Act of 1982 (DIA), Pub. L. No. 97-320, 96 Stat. 1469 (1982). This lending authority included the

Until recently, the OTS regulations specifically authorized Federal savings associations to issue commercial and standby letters of credit.¹³ In the recent rule on lending and investment, the OTS proposed to include an express authorization for letters of credit in the lending and investment chart at 12 CFR 560.30. However, the OTS deleted this authorizing provision in the final rule “because issuing a letter of credit is not in and of itself a loan or investment.” The OTS, nonetheless, included prudent standards for the issuance of letters of credit and other approved independent undertakings by all savings associations at 12 CFR 560.120. These standards, however, apply only to the extent that a savings association has legal power to issue and commit to issue letters of credit and other approved independent undertakings.

The deletion of § 545.48 has inadvertently created confusion as to whether Federal savings associations continue to hold authority to issue letters of credit and other approved independent undertakings. To clarify this point, the OTS is proposing to add a new section to part 560, subpart A, which addresses the lending and investment powers of Federal saving associations. While a letter of credit technically is

authority to make secured or unsecured loans for commercial, corporate, business, or agricultural purposes (currently 12 U.S.C. 1464(c)(2)(A)), and the authority to make loans on the security of liens upon nonresidential real property (currently 12 U.S.C. 1464(c)(2)(B)). The FHLBB reasoned that the DIA was intended to give Federal savings associations competitive parity with national banks with respect to credit services provided to business customers. Because the authority to issue commercial and standby letters of credit was a well-established incidental power of national banks, the FHLBB determined that this authority was also conferred on Federal savings associations. 48 FR 23032, 23043 (May 23, 1983). The FHLBB also noted that 12 U.S.C. 1464(b)(2), which authorizes Federal associations to act as surety, supported this determination.

¹³ 12 CFR 545.48 (1996), removed 61 FR 50951 (September 30, 1996).

neither a loan nor an investment, once funds are advanced under a letter of credit, the advance is treated as an extension of credit and is subject to investment limits and other restrictions on lending. See § 560.31(a). Accordingly, the OTS believes it is appropriate to place this new provision in part 560.

Proposed § 560.50 would state that a Federal savings association may issue letters of credit and such other independent undertakings as are approved by the OTS, subject to the restrictions of § 560.120. Like existing § 560.120, the new section uses the phrase “letters of credit and other independent undertakings.” The OTS has used this phrase to encompass letters of credit as well as all commitments where the Federal savings association’s obligation to honor the commitment is dependent solely on the proper presentation of specified documents regardless of extrinsic factors (except fraud, forgery, or an overriding public policy issue). The term covers a broad array of transactions including commercial letters of credit, standby letter of credit, and other undertakings that are functionally identical or equivalent to letters of credit.

In the thrift context, the broad scope of the term “independent undertakings” and its recent evolution require close supervision and review when such undertakings fall outside the more traditional activities generally known as letters of credit.

Accordingly, OTS believes that allowing Federal savings associations to issue independent undertakings of a type specifically approved by OTS strikes the appropriate balance between allowing a Federal savings association the flexibility to engage in such

transactions and, at the same time, ensuring that thrifts have properly evaluated the risks posed by a particular transaction consistent with prudent banking practice. OTS anticipates that its approval may take the form of legal opinions, general guidance, or case-by-case approvals, depending upon how the undertakings are presented to the agency.¹⁴

III. Escrow Accounts

Although the HOLA does not expressly address escrow accounts, the OTS and the FHLBB have authorized Federal savings associations to provide escrow services in several instances. For example, the FHLBB, in 1959 issued a policy statement permitting Federal savings associations to provide escrow services in connection with real estate loans. This policy statement provided:

A Federal savings association may not act generally as an agent for the public in handling escrows. It may, however, handle escrows relating to real estate loans it makes and, to the extent reasonably incidental to accomplishing its express purposes, may handle escrows for others involving the type of real estate transactions common to the savings association business.¹⁵

This policy statement remained substantively unchanged until 1996 when OTS removed it because the "authority to establish escrow accounts is subsumed within the authority of Federal savings associations to make loans and does not need to be specifically

¹⁴ See 61 FR 50951, 50958 (September 30, 1996).

¹⁵ 12 CFR 556.2 (1996).

identified in the CFR.”¹⁶

Some questions have been raised concerning the scope of Federal savings associations’ authority to handle escrow accounts that are not related to loans. For example, even while the policy statement was effective, the OTS indicated that fiduciary activities involving non-discretionary activities such as escrow or safekeeping services, or acting as a custodian or paying agent are implicit in the express powers of Federal savings associations, including deposit powers.¹⁷

More recently, the OTS issued an opinion stating that a Federal savings association may hold an account that would escrow funds representing down-payments on vacations for its customer, a vacation organizer.¹⁸ The OTS concluded that the activity fell within the incidental powers of Federal savings associations.¹⁹ The OTS reasoned that the proposed escrow service would allow the savings association to provide its customer with more convenient access to needed financial services and is, thus, consistent with Congress’ intent that Federal savings associations meet the needs of their business customers. Moreover, the OTS found that the proposed escrow

¹⁶ 61 FR 50951, 50961 (September 30, 1996).

¹⁷ OTS Regulatory Handbook: Trust Activities, § 140 (1992) and Op. Chief Counsel (October 17, 1995) (The authority to engage in these basic banking activities is derived from the incidental powers doctrine, not from section 5(n) of the HOLA. Thus, a Federal savings association is not required to obtain trust powers “to perform limited duties and responsibilities such as escrow, safekeeping, or custodian services, even though the performance of such duties requires a degree of trust and care.”)

¹⁸ OTS Op. Chief Counsel (August 19, 1998).

¹⁹ See OTS Op. Acting Chief Counsel (March 25, 1994) at 7-8 and (October 17, 1994) at 4-5, which set forth the

service is similar to deposit taking and other escrow, safekeeping and document custodian services that Federal savings associations are already authorized to conduct.

Further, the OTS noted that the proposed escrow activities would support funds intermediation by facilitating the conduct of financial transactions and would permit thrifts to compete more equally with commercial banks, which are permitted to provide such services.²⁰

While the OTS has not proposed any new regulatory text on escrow accounts in today's rulemaking, it requests comment whether it should issue a rule clarifying the scope of escrow authority of Federal savings associations. Commenters are also specifically asked to address whether the OTS should place any restrictions on the exercise of the escrow authority.

IV. Executive Order 12866

The Director of the OTS has determined that this proposed regulation does not constitute a "significant regulatory action" for the purpose of Executive Order 12866.

V. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, OTS certifies that

factors that OTS considers in its incidental powers analysis.

²⁰ In a OCC Letter No. 86-11 (1986), the OCC did not object to an impound arrangement where the bank without trust powers would receive as deposits the funds submitted by subscribers to a limited partnership.

this proposed regulation will not have a significant economic impact on a substantial number of small entities. Today's proposed rule would not impose any additional burdens or requirements on small entities. Rather, the proposed rule simply clarifies the authority of Federal savings associations to act as guarantor and issue letters of credit. While the proposed rule also restricts the circumstances under which Federal and state-chartered savings associations may enter into surety and guaranty agreements, the proposed restrictions are the minimum necessary for safe and sound operations and should not impose a significant burden on small savings associations.

VI. Unfunded Mandates Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OTS has determined that the proposed rule will not result in expenditures by state, local, or tribal governments or by the private sector of \$100 million or more. Accordingly, this rulemaking is not subject to section 202 of the Unfunded Mandates Act.

List of Subjects in 12 CFR Part 560

Consumer protection, Investments, Manufactured homes, Mortgages,
Reporting and recordkeeping requirements, Savings associations, Securities.

Accordingly, the Office of Thrift Supervision amends part 560 of chapter V, title 12, Code of Federal Regulations as set forth below:

Part 545 [Amended]

Part 560 - LENDING AND INVESTMENT

1. The authority citation for part 560 continues to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1701j-3, 1828, 3803, 3806; 42 U.S.C. 4106.

§ 545.103 [Redesignated as § 560.115]

2. Section 545.103 is redesignated as § 560.115 and revised to read as follows:

§ 560.115 Suretyship and Guaranty.

(a) May a savings association act as surety or guarantor? To the extent that a

savings association has legal authority to do so, it may enter into an agreement to act as surety or guarantor if the agreement meets the requirements of this section.

(b) What is a suretyship or guaranty agreement? Under a suretyship or guaranty agreement, a savings association is bound with its principal to pay or perform an obligation to a third person. Under a guaranty agreement, a savings association agrees to satisfy the obligation of the principal only if the principal fails to pay or perform.

(c) What requirements apply to these agreements? A savings association may enter into a suretyship or guaranty agreement if the agreement meets each of the following requirements:

(1) The savings association's obligations under the agreement are limited to a fixed dollar amount and are limited in duration.

(2) The savings association's performance under the agreement would create a loan or other investment that is authorized under applicable law.

(3) The savings association's obligation under the agreement is treated as a contractual commitment to advance funds to the principal under §§ 560.93 and 563.43 of this chapter.

(4) The savings association must take and maintain a perfected security interest in collateral sufficient to cover its total obligation under the agreement.

(d) What collateral is sufficient?

(1) The savings association must take and maintain a perfected security interest in real estate or marketable securities equal to at least 110 percent of its obligation

under the agreement, except as provided in paragraph (d)(2) of this section.

(i) If the collateral is real estate, the savings association must establish the value by a signed appraisal consistent with part 564 of this chapter. The savings association must consider the value of prior mortgages, liens or other encumbrances on the property, except those held by the principal to the suretyship or guaranty agreement.

(ii) If the collateral is marketable securities, the savings association must be authorized to invest in that security taken as collateral. The savings association must ensure that the value of the security is 110 percent of the obligation at all times during the term of agreement.

(2) The savings association may take and maintain a perfected security interest in collateral which is at all times equal to at least 100 percent of its obligation, if the collateral is:

- (i) Cash;
- (ii) Obligations of the United States or its agencies;
- (iii) Obligations fully guaranteed by the United States or its agencies as to principal and interest; or
- (iv) Notes, drafts, or bills of exchange or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank.

3. Section 560.45 is added to read as follows:

§ 560.45 Suretyship and guaranty authority.

A Federal savings association is authorized to enter into an agreement to act as surety or guaranty, subject to the restrictions in § 560.115 of this part.

4. Section 560.50 is added to read as follows:

§ 560.50 Letters of credit and other independent undertakings - authority.

A Federal savings association is authorized to issue letters of credit and may issue such other independent undertakings as are approved by the OTS, subject to the restrictions in § 560.120 of this part.

DATED: September 14, 1998

By the Office of Thrift Supervision.



Ellen Seidman
Director