Type: Bookletter
Section Number: BL-007
Section Title: Disclosure of Financial Forecasts
Old/Additional ID: (Original # 245-OFA)

March 2, 1990

To: The Chief Executive Officer
All Farm Credit System Institutions

From: Michael J. Powers, Director
Office of Financial Analysis

Subject: Disclosure of Financial Forecasts

Background

Since enactment of the Agricultural Credit Act of 1987, several Farm Credit (FC) institutions have expressed their desire to include prospective financial statements in stockholder disclosures associated with corporate restructuring proposals. Since a majority of the restructuring proposals developed under Title VII of the Farm Credit Act of 1971, as amended (Act), will have a significant impact on the future operations, financial strength, and capital adequacy of the constituent institutions involved, the Farm Credit Administration (FCA) agrees that disclosure of prospective financial information as a part of the disclosure materials would provide important information relevant to the stockholders' voting decision.

Disclosure of Financial Forecasts to Stockholders

The FCA encourages FC institutions to disclose financial forecasts to stockholders when submitting corporate restructuring proposals to stockholders pursuant to Title VII of the Act, provided that the disclosure complies with the guidelines contained in Accounting Bulletin No. 90-1 "Disclosure of Prospective Financial Statements to Stockholders" (Attachment A). The accounting bulletin requires the disclosure be made in accordance with the "Guide for Prospective Financial Statements" issued by the American Institute of Certified Public Accountants (AICPA Guide). The accounting bulletin is effective immediately. Also attached is a checklist for presentation and disclosure of financial forecasts to stockholders (Attachment B). The checklist is based on the AICPA Guide.

Disclosure of Financial Forecasts to the FCA

Financial forecasts prepared solely for use by the FCA in support of an institution's restructuring proposal will be regarded as limited use financial forecasts. While we encourage FC institutions to disclose financial forecasts to stockholders in accordance with the AICPA Guide, at a minimum, the FCA requires FC institutions to file a limited use financial forecast at the time the FCA's approval of a restructuring proposal is requested. In so doing, FC institutions should follow the FCA guidelines established in its bookletter(s) and letters to FC institutions containing the instructions for submission of restructuring proposals to the FCA. Such limited use financial forecasts should not be disclosed to stockholders.

For filing of limited use financial forecasts with the FCA, FC institution should, at a minimum, include: (1) dividers that clearly separate the limited use financial forecasts from the disclosure documents to be submitted to stockholders; (2) prospective financial statements of the resulting entity of the restructuring proposal, i.e., balance sheet and income statement, covering at least 3 years of future operations in addition to the current year (full year) financial statements; (3) permanent capital ratios for the forecast period; and (4) summaries of significant assumptions used to develop the forecast and accounting policies.

Financial assumptions may be disclosed in computer printout or electronic spreadsheets, and disclosure of accounting policies may be accomplished by cross-referencing to the information contained elsewhere in the documents submitted. The FCA may require additional information to support the reasonableness of the assumptions used in the forecast or "what if" scenarios, e.g., the best and/or the worse cases, as considered necessary.

Guidelines for Disclosure of Forecasts to Stockholders vs. Disclosure of Forecasts to the FCA

Financial forecasts prepared for disclosure to stockholders may not be appropriate for filing with the FCA for limited use and vice versa. For instance, while a financial forecast covering 1 full year of operations may be appropriate for disclosure to stockholders, the forecast does not meet the FCA's requirement, i.e., a limited use financial forecast must include at least a 3-year forecast period. We suggest that FC institutions refer to the guidelines contained in the attached checklist for development of limited use financial forecasts. The completed checklist is to be submitted to the FCA regardless of whether the forecast is to be disclosed to stockholders or to the FCA only.

Please direct any inquiries regarding this letter to the Financial Analysis and Standards Division at (703) 883-4475.

Attachments

Accounting Bulletin 90-1 **Attachment A**

Subject: Disclosure of Prospective Financial Statements to Stockholders

Statement of Accounting Policy

Farm Credit Administration (FCA) Regulation 621.3(b) requires each institution of the Farm Credit System to "Prepare its financial statements and reports, . . . in accordance with generally accepted accounting principles, except as otherwise directed by statutory and regulatory requirements or otherwise required by the Farm Credit Administration." Though FCA regulations do not require disclosure of a financial forecast to stockholders when submitting a restructuring proposal to stockholders for voting, the FCA encourages Farm Credit (FC) institutions to disclose financial forecasts to stockholders, provided that management has a reasonable basis for a forecast and the forecast is prepared and presented in accordance with the "Guide for Prospective Financial Statements" issued by the American Institute of Certified Public Accountants (AICPA Guide). In addition, financial forecasts to be disclosed to stockholders may, but are not required to, include an outside reviewer's report, provided such report includes a disclosure of the reviewer's qualifications, the relationship of the reviewer to the issuing institution, and the extent of the review.

Application of the Accounting Policy

This accounting bulletin is effective immediately and applies to all FC institutions' prospective financial statements disclosed to stockholders in conjunction with corporate restructuring proposals submitted to stockholders under Title VII of the Farm Credit Act of 1971, as amended (Act).

Background

The Agricultural Credit Act of 1987 provided additional alternatives to the FC institutions for corporate restructurings. A majority of the proposals developed under the restructuring provisions (Title VII) of the Act will have a significant impact on the operations, financial strength, and capital adequacy of the constituent institutions involved. In order to provide meaningful information to stockholders such that they may make an informed decision, several institutions have expressed their desire to include prospective financial statements in their disclosure to stockholders. The FCA agrees that disclosure of prospective financial information would be beneficial to stockholders and, therefore, issues guidance to permit the institutions to disclose financial forecasts, on a voluntary basis, to stockholders for restructuring proposals developed under Title VII of the Act.

Please direct any inquiries regarding this accounting bulletin to the Financial Analysis and Standards Division at (703) 883-4475.

John C. Moore, Jr., Deputy Chief
Financial Analysis and Standards Division Date: March 2, 1990

Attachment B

Presentation and Disclosure of Financial Forecasts to Stockholders in Accordance with the AICPA Guide for Prospective Financial Statements

____
(Name of the Reporting Entity)

GENERAL INFORMATION

1. Disclosure of Financial Forecasts to Stockholders

   a. Farm Credit institutions (FCIs) may disclose prospective financial statements (PFS) to stockholders, provided that the preparation and presentation of the PFS meets the requirements of the "Guide for Prospective Financial Statements" issued by the American Institute of Certified Public Accountants (AICPA Guide). Financial forecasts that are prepared for general use may be presented to stockholders. Financial projections and partial presentations should not be disclosed to stockholders, unless these presentations are included in a financial forecast as a supplement to the forecast.

   b. This checklist includes the presentation and disclosure requirements for financial forecasts set forth in the AICPA Guide. References to the paragraph numbers of the AICPA Guide and other authoritative literature are cited for each line item.

   c. The items with an asterisk (*) at the end of the question represent additional items the FCA believes are necessary to adapt the AICPA Guide to adequately portray the prospective operation of FCIs. FCIs' presentations of financial forecasts should meet the minimum presentation guidelines detailed in the AICPA Guide and include additional information required by the FCA.

   d. Use of the "Comments" section on the last page of the checklist to bring unusual matters to the attention of the FCA.

2. **Import Terms**—The terms used in this checklist have the same meaning as those used in the AICPA Guide.

   a. **Financial forecast**—PFS that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operation, and cash flows.

   b. **Financial projection**—PFS that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operation, and cash flows.

   c. **General use**—Refers to the use of prospective financial statements by persons with whom the responsible party is not negotiating directly, e.g., in an offering statement of an entity's debt or equity interest.

   d. **Hypothetical assumption**—An assumption used in a financial projection to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the projection.

e. **Prospective financial statements**—Refers to either financial forecasts or financial projections, including the summaries of significant assumptions and accounting policies. Pro forma financial statements and partial presentations are not considered prospective financial statements.

f. **Partial presentation**—Presentations of prospective financial statements that do not meet the minimum presentation guidelines of the AICPA Guide.

g. **Responsible party**—The person or persons who are responsible for the assumptions underlying the PFS. The responsible party usually is management.

3. **Documentation**—Though the terms "financial forecast" and "financial projection" are defined in the AICPA Guide, it is ambiguous as to what constitutes a forecast or a projection. It is sometimes difficult to determine whether one or more assumptions used to develop the prospective financial statements represents a course of action that is expected to occur or a hypothetical condition. Therefore, each issuing institution must ensure that it maintains appropriate documents to support the reasonableness of the assumptions used in the forecast and such documents shall be subject to review by the FCA.

4. **Submission of Checklist and Financial Forecast**—Each financial forecast submitted to the FCA shall be accompanied by a completed transmittal sheet and the presentation and disclosure checklist.

5. **Evaluation Criteria**—FCA's evaluation and approval of financial forecasts for disclosure to stockholders will be made based upon the requirements set forth in the AICPA Guide. The FCA may require the responsible party to submit additional information to support the reasonableness of the underlying assumptions of the forecast. And upon the request of the FCA, the responsible party must demonstrate to the FCA that the preparation of the institution's forecast meets the following requirements:

   a. Financial forecasts are prepared in good faith.

   b. Financial forecasts are prepared with appropriate care by qualified personnel.

   c. Financial forecasts are prepared using appropriate accounting principles.

   d. The process used to develop financial forecasts provides for seeking out the best information that is reasonably available at the time.

   e. The information used in preparing financial forecasts is consistent with the plans of the entity.

   f. Key factors are identified as a basis for assumptions.

   g. Assumptions used in preparing financial forecasts are appropriate.

   h. The process used to develop financial forecasts provides the means to determine the relative effect of variations in the major underlying assumptions.

   i. The process used to develop financial forecasts provides adequate documentation of both the financial forecasts and the process used to develop them.

   j. The process used to develop financial forecasts includes, where appropriate, the regular comparison of the financial forecasts with attained results.

k. The process used to prepare financial forecasts includes adequate review and approval by the responsible party at the appropriate levels of authority.

TRANSMITTAL SHEET

Farm Credit District ____

Requested action for which the forecast is prepared:
____

Disclosure of the forecast to stockholders: Yes ____ No ____

Forecast completed by: ___________________ Tel: (___) ______________

Prospective period ending: ____

Completion date of the forecast: ____

Name of the requesting Farm Credit institution(s):
____

CEO Name: ___________________ Telephone: (___)
Street Address: ____
Mailing Address: ____
City, State, Zip: ____
County: ____

CEO Name: ___________________ Telephone: (___)
Street Address: ____
Mailing Address: ____
City, State, Zip: ____
County: ____

CEO Name: ___________________ Telephone: (___)
Street Address: ____
Mailing Address: ____
City, State, Zip: ____
County: ____

CEO Name: ___________________ Telephone: (___)
Street Address: ____
Mailing Address: ____
City, State, Zip: ____
County: ____

CHECKLIST

Indicate Y (yes), N (no), or N/A (not applicable). And, if applicable, include the page number or other index number where the information is presented. Explanations must be provided for each question answered with an "N" in the Comments section at the end of the checklist.

TITLE

___ 1. Does the title of the forecast describe the nature of the presentation and include the word "forecast" or "forecasted," e.g., "Forecasted Balance Sheet" or "Statement of Forecasted Income?" (AICPA Guide 400.05)

___ 2. Does the title indicate the prospective period covered and use the word "ending" to indicate its prospective nature, e.g., "Year Ending 199X?" (*)

___ 3. If a historical statement also is presented, does the title indicate the historical presentation and describe the period covered with the word "ended," e.g., "Year Ending December 31, 19X1 (Forecasted), and Year Ended December 31, 19X0 (Historical)?" (*)

PRESENTATION

___ 4. If a forecast and a projection (included as a supplement to the forecast) are presented together, or if prospective and historical information are presented together, is each column clearly labeled? (Note: For general use, a projection may supplement a forecast provided it does not extend beyond the forecast period.) (AICPA Guide 210.05, 400.20, and 400.34)

___ 5. If a presentation of a financial forecast is made for other than a single-point estimate (i.e., as a range), is there a clear indication that the presentation does not necessarily represent the best or worst possible alternatives? (AICPA Guide 400.21)

___ 6. Does the presentation cover at least one full year of normal operations? (AICPA Guide 400.32)

___ 7. If long-term results are important to the presentation: (AICPA Guide 400.33)

  ___ a. have enough future periods been presented to demonstrate the long-term results, or

  ___ b. if not practical, does the presentation include a description of the potential effect of such results?

___ 8. If there is a significant start-up period, has it been presented separately? (AICPA Guide 400.32)

___ 9. Have the name, form, and equity components of an entity yet to be formed been disclosed (or if they have not been decided, has that fact been disclosed)? (AICPA Guide 400.32)

___ 10. Are the following minimum financial statement elements disclosed (this requirement would be met if these items can be derived from the financial statements or the notes): (AICPA Guide 400.06)

  ___ a. interest income and gross loan volume?

___ b. interest expense or net interest margin?

___ c. allowance for loan losses and provision for loan losses? (*)

___ d. unusual or infrequently occurring items?

___ e. other operating expenses? (*)

___ f. provision for income taxes?

___ g. extraordinary items?

___ h. income before taxes?

___ i. net income?

___ j. permanent capital ratio? (*)

___ k. significant changes in cash flows?

___ l. significant changes in permanent capital? (*)

DISCLOSURE ON FACE OF STATEMENTS

___ 11. Does each page of the presentation contain a reference such as "See accompanying summaries of significant assumptions and accounting policies?" (AICPA Guide 400.10)

___ 12. Is a summary of significant assumptions presented? (AICPA Guide 400.22)

ASSUMPTIONS

___ 13. Is the basis or rationale for the assumptions disclosed? (AICPA Guide 400.22)

___ 14. Is there an introduction to the summary of assumptions that does the following:

___ a. indicates the assumptions disclosed are not all-inclusive? (AICPA Guide 400.28)

___ b. states that the assumptions were based on the responsible party's judgment at the time the prospective information was prepared? (AICPA Guide 400.28)

___ c. describes what the presentation is intended to present? (AICPA Guide 400.28)

___ d. indicates the date of preparation of the presentation? (AICPA Guide 400.11)

___ e. includes a caveat that the prospective results may not be attained?

___ f. includes a statement that the responsible party does not intend to update the presentation (optional)? (AICPA Guide 400.38)

___ g. if the presentation is a range, includes a statement that the responsible party expects the results to fall within the range although there can be no assurance that they will? (AICPA Guide 400.30)

___ 15. Are the following types of assumptions disclosed:

___ a. particularly sensitive assumptions, noting that they are particularly sensitive? (AICPA Guide 400.24)

___ b. assumptions about anticipated conditions, if there is a reasonable possibility that they will be significantly different from current conditions, if not reasonably apparent? (AICPA Guide 400.23)

___ c. significant implicit assumptions that current conditions will prevail, e.g., continued absence of war, natural disasters, and so on (disclosure is needed only if there is a reasonable possibility that the current conditions will not prevail)? (AICPA Guide 400.26)

___ d. other significant matters deemed important? (AICPA Guide 400.23)

___ 16. Are hypothetical assumptions in a projection disclosed and identified as hypothetical? (if applicable, see item No. 4) (AICPA Guide 400.23P)

___ 17. Is there an indication of which hypothetical assumptions, if any, are improbable? (if applicable, see item No. 4) (AICPA Guide 400.23P)

___ 18. If an updated prospective presentation is issued, is the reason for updating disclosed in the summary of significant assumptions? (AICPA Guide 400.38)

<u>ACCOUNTING PRINCIPLES AND POLICIES</u>

___ 19. Are significant accounting policies disclosed? (AICPA Guide 400.12)

___ 20. Is the prospective presentation prepared on the same basis of accounting expected to be used for the historical financial statements? (AICPA Guide 400.15)

If not:

___ a. Are the results of operations and cash flows in the prospective presentation reconciled with the results that would have been obtained using the basis for historical statements? or

___ b. If such a reconciliation would not be useful, have the principal differences between the two bases been described?

___ 21. If the presentation is a forecast, are the accounting principles used the same as those expected to be used in the historical statements covering the prospective period? (AICPA Guide 400.13)

___ 22. If the presentation includes a projection (see item No. 4) and the accounting principles used are not the same as those expected to be used in the historical statements covering the prospective period: (AICPA Guide 400.13P)

___ a. Is the use of the different principles disclosed? (Differences between two principles may also be reconciled and disclosed.)

___ b. Is the use of different principles consistent with the purpose of the presentation?

___ 23. If the prospective statement gives the effect of a change in accounting principles from a principle used in prior-period historical financial statements, is the change properly reported as would be required in historical statements? (AICPA Guide 400.16)

___ 24. If a forecast is accompanied by an outside reviewer's report, are the reviewer's qualifications, the relationship of the reviewer to the issuing entity, and the extent of the review disclosed? (Optional)

Comments: ____
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Type: Bookletter
Section Number: BL-009 REVISED
Section Title: Farm Credit Bank and Association Appointed Directors
Old/Additional ID: (Original # 260-OE)

December 15, 2006

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Farm Credit Bank and Association Appointed Directors

Congress recognized that, in a cooperative, a board of directors needs the authority to appoint a limited number of directors. In 1987, Congress added to the Farm Credit Act of 1971, as amended (Act), the authority for Farm Credit banks and associations to appoint directors, including at least one director who has no affiliation with the Farm Credit System (outside director). Congress explained that directors appointed under this authority are intended to provide an independent perspective and some additional expertise in appropriate areas.[1] In January 2006, FCA issued a final rulemaking addressing the governance of Farm Credit banks and associations. In this rulemaking, the eligibility, term of office, number and selection of outside directors was addressed in § 611.220 of FCA regulations and the definition of "outside director" was provided in FCA regulation § 619.9235.[2] The rule is silent, however, on the eligibility, term of office, number and selection of other appointed directors.

Background

FCA believes it is permissible under the Act for Farm Credit bank and association boards of directors to appoint stockholders to serve as directors (other appointed directors), except that associations may only appoint voting stockholders under sections 2.1 and 2.11 of the Act. The overarching objectives in selecting outside directors and other appointed directors is to enhance and strengthen the governance of the institution as well as to enhance the capacity of the board of directors to represent the interests and concerns of the institution's owner-borrowers. Consistent with these objectives, bank and association boards may appoint directors for specific public policy purposes, such as facilitating diversity or acquiring needed skills. In considering the selection of other appointed directors, each bank and association should balance the desire for optimum size boards against the identified need to add certain skills or improve diversity.

FCA believes that the authority to appoint directors, when used appropriately, does not impinge on corporate democracy or jeopardize the status of a Farm Credit bank or association as a cooperative. FCA emphasizes that stockholders in a cooperative have the right to vote for directors, and, therefore, use of director appointments is, by necessity, limited. Accordingly, FCA recently established a requirement that each Farm Credit bank and association board must consist of at least 60 percent stockholder-elected directors.[3] Bank and association boards should carefully consider the overriding cooperative principle of stockholder control and should not treat the regulatory 60 percent stockholder-elected director requirement as a maximum requirement.

Policy on Appointing Directors

FCA expects each Farm Credit bank and association board to develop and adopt a policy that formalizes compliance with the appointed director provisions of the Act by addressing the purpose for, and the search and selection processes of, appointing directors to the board. The policy should describe the appointment process and explain how the appointed director(s) add diversity or skills to the board, thereby strengthening the board's governance. To facilitate identifying the skills needed on the board of directors, each bank and association is required, under § 611.210(a), to establish a written policy identifying desirable director qualifications. This requirement is applicable to all director positions. As a result, banks and associations must make a reasonable effort to appoint outside directors and other appointed directors who have some or all of those desired qualifications.[4]

All directors have the same fiduciary responsibilities to each institution's stockholders, regardless of how they are selected. All directors must also have the same voting rights, and related responsibilities and duties, and be subject to the same rules and requirements, including requirements on pledges of confidentiality, disclosures, and conflicts of interest. Therefore, outside directors and other appointed directors have full voting rights on all matters that come before the board of directors. Accordingly, no director sitting on the board at the time of the vote should be denied the opportunity to vote on the appointment of additional directors.[5]

The policy should also address the removal procedures developed pursuant to § 611.220(b). Although § 611.220(b) requires Farm Credit banks and associations to establish and maintain procedures for the removal of outside directors, institutions may find the procedures appropriate for all appointed directors. The FCA believes that the term of office[6] and basis for removal should be the same for all directors serving on the institution's board. In addition, an outside director must be removed if the director becomes an officer, employee, stockholder, or agent of any Farm Credit institution or a director of another Farm Credit institution. FCA encourages institutions to amend their bylaws to address an appointed director's length of service and basis for removal.

Conflicts of Interest

Appointed directors must be willing and able to assume the responsibilities, exercise the authority, and comply with the same regulatory requirements, including standards of conduct and conflicts of interest, as stockholder-elected directors. Appointed directors are subject to FCA standards-of-conduct (Part 612) regulations and disclosure regulations (Part 620). Farm Credit institution boards must exercise diligence in the selection of appointed directors to avoid any conflicts of interest, whether actual or perceived, and to ensure that such individuals can function in a totally impartial manner. Selection of appointed directors who have ongoing business or borrowing relationships with the institution demands increased caution to ensure compliance with applicable regulations. Boards of directors that are engaged in merger discussions should avoid using their appointment authority to transition the boards just because they cannot agree on a governance plan for the continuing institution.

Institutions are reminded that § 611.310, which prohibits a person from serving as a director if that person was a salaried officer or employee of any Farm Credit bank or association at any time during the previous year, applies to all directors, including appointed directors. Banks and associations might use a similar cooling-off period prior to appointing any individual who unsuccessfully sought a stockholder-elected seat on the board in a recent election. Use of this type of a cooling-off period further preserves the cooperative principles on which the Farm Credit System is formed by honoring the voting stockholders' decision not to elect the individual as a director in that election cycle.

Use of the Term "Director"

We are aware that some institutions have used terms such as "Associate Director" or "Director Emeritus" even though the designated individual does not have the same rights, duties, and responsibilities as other directors. Use of an honorific containing the term "director" creates confusion for stockholders, employees, and the FCA as to the person's responsibilities and whether the person is subject to FCA rules on director qualifications, training, conflicts of interest, disclosures, and reporting. Therefore, we discourage institutions from using the term "director" for anyone not having a director's full responsibilities.

If a Farm Credit bank or association board desires to include positions that are not full directorships, the board should use an alternate title, such as "advisor to the board." If an institution decides to retain "director" in titles for positions that are not full directorships, then the institution should make it clear to all stockholders, employees, and the FCA what the limitations of the position are, as well as ensure the confidentiality of proprietary information that may be shared with individuals occupying such positions.

For further information on director conduct and responsibilities, please refer to the handbook titled The Director's Role available on FCA's website at www.fca.gov. Any comments or questions on this communication should be addressed to Andrew D. Jacob, Director, or Gary Van Meter, Deputy Director, in the Office of Regulatory Policy at (703) 883-4414, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov.

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[1]Congress "believed it would be prudent for all boards to have a disinterested, objective member . . . ." 133 *Cong. Rec.* S. 16831 (December 1, 1987).

[2]12 C.F.R. 619.9235 defines "outside director" as "[a] member of a board of directors selected or appointed by the board, who is not a director, officer, employee, agent, or stockholder of any Farm Credit System institution."

[3]12 C.F.R. 611.220(a)(2).

[4]12 C.F.R. 611.220(a)(1).

[5]The only exception is that an appointed director cannot vote in his or her own selection and removal.

[6]Certain events, such as mergers, consolidations, or mid-term board vacancies, may cause a temporary difference in the terms of office for all directors; however, these events would apply to all directors whether elected or appointed.

Copy to: The Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

Type: Bookletter
Section Number: BL-010
Section Title: Farmers Home Administration (FmHA) Guaranteed Loans -- Capitalization of Interest
Old/Additional ID: (Original # 271-OE)

October 16, 1990

To: The Chief Executive Officer
All Farm Credit Institutions

From: David C. Baer, Director
Office of Examination

Subject: Farmers Home Administration (FmHA) Guaranteed Loans—Capitalization of Interest

During the course of certain Farm Credit institution (FCI) examinations, Farm Credit Administration examiners have found that provisions in notes on FmHA-guaranteed loans permit the compounding of interest. We requested the FmHA to review those provisions and inform us of any impact on the validity of the guarantee.

The FmHA has responded that all guaranteed loans governed by Lender Agreements revised May 16, 1983, and later, are void if the promissory note provides for the payment of interest on interest.

The two examples that FmHA reviewed and indicated would void the guarantee are shown below:

1. COMPOUNDING AT MATURITY-DEFAULT INTEREST. If all or any part of this total amount due under this Note or any installment thereof is not paid at maturity, whether maturity occurs by reason of acceleration or otherwise, then at the Association's option, all remaining accrued interest shall be added to the past due principal balance. After maturity, the outstanding principal balance, including compounded interest, if any, shall bear interest at the default rate.

2. ADDITIONAL AGREEMENTS AND OBLIGATIONS OF PARTIES. The borrowers, endorsers, sureties, guarantors, and all other persons who may become liable for all or any part of the indebtedness evidenced hereby severally agree to the following:

   "That if this Note is placed in the hands of an attorney for collection or to protect or enforce any of the Association's rights hereunder, their liability to the Association shall extend to and include, to the extent permitted by applicable federal or state law, reasonable attorney's fees not to be less than 20% of the sum of unpaid principal, compounded interest, and accrued interest together with all court costs and all other fees, costs and expenses paid or incurred by the Association in connection with the collection of this loan."

If your institution's note form contains the above or similar provisions which permit capitalizing interest at default on FmHA-guaranteed loans, then the note must be corrected to ensure the FmHA guarantee is valid.

The FmHA has suggested that affected FCIs contact the respective FmHA state director concerning making any necessary amendments to promissory notes.

FCA examines will continue to review and classify FmHA-guaranteed loans based upon a determination of the validity of the guarantee.

Type: Bookletter
Section Number: BL-011
Section Title: Farm Credit Investment Bonds
Old/Additional ID: (Original # 279-OE)

December 20, 1990

To: The Chief Executive Officer
Each Farm Credit Bank
Federal Farm Credit Banks Funding Corporation

From: David C. Baer, Director
Office of Examination

Subject: Farm Credit Investment Bonds

Attached is a copy of a letter from the Department of the Treasury to Chairman Steele granting exemption from the provisions of sections 15C(a), (b), and (d) of the Securities and Exchange Act of 1934 as amended by the Government Securities Act of 1986 (Pub. L. 99-571, 100 Stat. 3208, 15 U.S.C. 780-5(a), (b), and (d)) to all associations of the Farm Credit System with respect to the sale of Farm Credit Investment Bonds. The letter describes in some detail the requirements with which any investment bond program must comply to maintain the exemption granted.

Those banks and associations that sell investment bonds should evaluate their programs to assure strict compliance with these requirements. FCA examiners will be reviewing and investment bond program in future examinations. In these examinations, particular attention will be given to the adequacy of disclosure of the characteristics of the instrument being sold and the financial condition of the selling institution and to compliance with the procedural restrictions on association involvement in the program.

Attachment

DEPARTMENT OF THE TREASURY
BUREAU OF THE PUBLIC DEBT
WASHINGTON, D.C. 20239-0001

November 26, 1990

Dear Mr. Steele:

We have received letters from the Farm Credit Bank of St. Paul and the Production Credit Association of Minnesota Valley (June 12, 1990), and the Western Farm Credit Bank and several associations in the Western District (June 21, 1990) requesting exemptions from the provisions of Sections 15C(a), (b), and (d) of the Securities Exchange Act of 1934 (Exchange Act), as added by the Government Securities Act of 1986 (GSA) (Pub. L. 99-571, 100 Stat. 3208, 15 U.S.C. 78o-5(a), (b), and (d)). The requests for exemptions stem from activities conducted in connection with the sale of Farm Credit Investment Bonds. The two requests are similar to a request for exemption from registration previously submitted by the Farm Credit Bank of Baltimore and Keystone Farm Credit ACA (Keystone), dated October 4, 1989. An exemption was granted in response to that request.[1]

In consideration of the requests precipitating this response, we examined the Investment Bond program for the entire Farm Credit System. We understand the salient facts to be as follows.

A. Structure of the Farm Credit System Institutions

The Farm Credit Banks (FCBs) are federally-chartered instrumentalities of the United States, created by the mandatory mergers of Federal Land Banks and Federal Intermediate Credit Banks, as provided for in Section 410 of the Agricultural Credit Act of 1987 (1987 Act) (Pub. L. 100-233 (uncodified); 12 U.S.C. 2011 note). The FCBs, as part of the Farm Credit System, are subject to regulation and examination by the Farm Credit Administration (FCA) (12 U.S.C. 2002 and 2254). The FCBs and other institutions comprising the Farm Credit System are intended to serve the credit needs of farmers and ranchers, while encouraging participation in the management, control, and ownership of the system (See 12 U.S.C. 2001).

One of the primary functions of the FCBs is to provide funding for the lending operations of the various associations within each of their territories. These associations, created or continued pursuant to the 1987 Act, are: Federal Land Bank Associations, Federal Land Credit Associations, Production Credit Associations, and Agricultural Credit Associations.[2] Like FCBs, these associations are regulated and examined by the FCA. They are, by statutory designation, or as the result of statutorily-mandated mergers, federally-chartered instrumentalities of the United States.

Eligible borrowers of the different associations include farmers, ranchers, producers, harvesters of aquatic products, and other eligible persons as described in the Farm Credit Act of 1971, as amended by the 1987 Act, and regulations of the FCA (12 U.S.C. 2017 and 12 CFR 613 Subpart B).

In order to obtain a loan from any of the associations, a borrower must become a member by purchasing stock or participation certificates in an amount required by the association's by-laws. Thus, each association, a federally-chartered instrumentality of the United States, is owned by its member-borrowers. The board of directors of each association consists of stockholders elected by its voting membership, and one board member, selected by other members of the board, who is not a stockholder, officer, employee, or director of any Farm Credit System institution.[3]

B. The Investment Bond Program

The transactions that are the subject of the requests for exemptions involve instruments referred to as Farm Credit Investment Bonds (IBs). IBs are issued by, and are obligations of, individual FCBs, and are issued pursuant to 12 U.S.C. 2153(b), (e), and the regulations of the FCA (12 CFR 615.5110-5130). IBs are government securities pursuant to Section 3(a) (42) (B) of the Exchange Act (15 U.S.C. 78c(a) (42) (B)), having been designated by the Secretary of the Treasury for exemption pursuant to Section 3(a) (12) of the Exchange Act (15 U.S.C. 78c(a) (12), 43 FR 24933). The FCA consults with Treasury regarding the issuance of IBs (12 CFR 615.5000(e)).

The IBs to be issued by the various FCBs are subject to a number of limitations imposed by statute and the FCA. These limitations include, among other things, that issuance of the bonds be subject to approval by the FCA and that the eligible purchasers be limited to employees, retired employees, and members of FCBs and associations within the issuing FCB's territory. IBs are issued, subject to instructions of the FCA regarding their terms, at varying maturities, interest rates, minimum investments, penalties for early redemptions, and reinvestment terms. While IBs can be issued in definitive form, it has been represented that they are currently issued only in book-entry form.

C. Involvement of the Associations in the Investment Bond Program

Some FCBs have proposed that interested associations in their respective districts provide certain services related to the sale of IBs. It is the nature of these services which has raised questions concerning a need to register and ultimately to the requests for exemptions. It has been represented that the involvement of associations with respect to the sale of the IBs would be limited to certain specified activities that have been represented as clerical and/or ministerial in nature, and limited to the following.

The associations would stock and make available printed informational materials provided by the FCB issuing the IBs and would not provide any information other than that set forth in the printed materials. The printed materials will clearly state that the FCBs and not the associations are the issuers of the IBs.

Any association member or employee that wanted to purchase an IB could contact their association's office or the respective FCB. The association or FCB would obtain the necessary information to issue the IB. If obtained at the association, it has been represented that the information is transmitted to the FCB, and the appropriate book-entry record creating the security is recorded based upon the information.

It has been represented that funds to purchase IBs are made directly payable to the FCB and, in some instances, may be directly transmitted. Upon redemption of the IBs, the proceeds are issued directly from FCBs to investors. The associations do not maintain custody of customer funds.

It has been represented that FCBs compensate associations for their costs associated with the sale of IBs. Different methods of calculating reimbursement for actual expenditures have been described to Treasury. In all cases, the level of reimbursement is left to the discretion of the FCB and the amounts may or may not equal the costs of distribution. The FCB can unilaterally adjust the amounts of reimbursement. It has been represented that while reimbursement may be based on a percentage of the principal amount or a percentage of the savings realized from obtaining lower cost funds through the sale of IBs, there are no commissions or any transaction-based compensation paid to employees in connection with the sales of IBs, and that in no circumstance, are fees charged to investors by the associations.

Furthermore, it has been represented that the activities of the FCBs and associations with regard to IBs, including the content and distribution of the printed informational materials, are reviewed by the FCA as part of its regular examination procedures. We also understand that associations with direct lending authority are examined on an annual basis while those with indirect lending authority are examined on-site every three years (off-site examinations are conducted during the intervening years (See 12 U.S.C. 2254)).

It has been represented that the activities conducted by the associations are ministerial and clerical in nature not amounting to those of a broker. However, to the extent that an association's activities could be considered to be those of a broker, it has been requested that the association be exempted from the registration requirements set out at Section 15C of the Exchange Act in light of the limited nature of the IB program and existing federal oversight.

D. Request for Exemption and Treasury's Response

We have discussed in our previous letter to Keystone and the Farm Credit Bank of Baltimore the roles of the FCBs and various associations, as part of the Farm Credit System, in providing the United States agricultural sector with a dependable source of credit. Since interest in receiving exemptions extends beyond one FCB district, we have decided to evaluate the requests for exemptions submitted by the Farm Credit Bank of St. Paul and the Western Farm Credit Bank in the context of the entire Farm Credit System. Given these considerations, and the representations that have been made in the letters requesting exemptions, we have determined that exemptions from the registration requirements of Section 15C of the Exchange Act and the regulations thereunder are warranted and should apply to all associations within the Farm Credit System. These exemptions are granted without consideration of whether the activities conducted by the FCBs and associations are those of a government securities broker or dealer.

In order to ensure that investors are sufficiently protected, however, the exemptions are subject to the limitations described below. We have determined that these exemptions are consistent with the public interest, the protection of investors, and the purposes of the GSA given the current structure of the Farm Credit System, the unique nature of the IBs, and the limited activities of the associations and their employees. We have consulted with the staff of the Securities and Exchange Commission as well as the FCA in reaching this decision.

Accordingly, pursuant to 15 U.S.C. 78o-5(a) (4), we hereby grant exemptions from the provisions of Sections 15C(a), (b), and (d) of the Exchange Act (15 U.S.C. 78o-5(a), (b), and (d)), and the regulations thereunder, to the various associations that comprise the Farm Credit System with request to the aforementioned securities transactions subject to the following limitations: (i) that the activities of the associations with respect to the IBs be limited to the stocking and distributing of the informational materials furnished by the FCBs and the taking and transmitting of investor information needed to effect sales; (ii) that any responses by employees to investor questions will be limited to relating information contained in the informational materials, and no employee will discuss the merits of, or recommend the purchase of, IBs or any other security; (iii) that the printed materials clearly state that the FCB and not the association is the issuer of IBs, that IBs are not direct obligations of the United States, and that IBs are in no way insured or guaranteed as to principal or interest by the United States or any governmental entity; (iv) that all sales of IBs arranged by the associations take place on the premises of the associations; (v) that the associations may not maintain custody of customer funds in connection with purchases and redemptions of IBs (i.e., funds for purchases of IBs must be directly payable to the FCB and all proceeds (redemption and interest) are made directly from the FCB to investors);[4] (vi) that association employees may not receive any compensation related to transactions in IBs; (vii) that associations may not charge a fee to investors; and (viii) that the IB program, including the content of informational materials, will be subject to regular examination by the FCA.

These exemptions pertain only to the sale of IBs within a single FCB district (i.e., an association in one district may not distribute IBs issued by an FCB of another district). Any change in the facts or circumstances of your request would require further analysis and could lead to termination of the exemptions.

Pursuant to 17 CFR 400.2(c) (7) (i), the incoming letters and this response will be made immediately available to the public.

Sincerely,

Richard L. Gregg
Commissioner

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[1] Letter from Richard L. Gregg to Glen L. Stevens and Bernard C. Flory (March 5, 1990) granting request for exemption from registration.

[2] See amendments to 12 CFR 613-616, and 619 set out at 55 FR 24861 (June 19, 1990) which reconcile the authorities of institutions created by mergers required or authorized by the 1987 Act.

[3] 12 U.S.C. 2072 (Production Credit Associations), 2092 (Federal Land Bank Associations). As merged associations, Federal Land Credit Associations and Agricultural Credit Associations derive similar structures from their comprising entities.

[4] In a previous exemption granted to Keystone and all other Agricultural Credit Associations within the Farm Credit Bank of Baltimore District (March 5, 1990), it was represented that redemptions were handled through a zero balance account maintained by Keystone at a depository institution. Treasury has informed Keystone and the Farm Credit Bank of Baltimore that if the associations wish to remain exempt from the registration and regulatory requirements, all proceeds must be issued directly from the Farm Credit Bank of Baltimore to the customer. The associations have been given 60 days from the date of this letter to comply with this requirement.

Harold B. Steele, Chairman
Farm Credit Administration
Farm Credit Building
1501 Farm Credit Drive
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cc: David C. Baer, FCA
Nancy E. Lynch, FCA

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James M. Schurr, President
Farm Credit Services of Southern California, ACA

John J. Spano, President
Pacific Coast Production Credit Association and
Pacific Coast Federal Land Bank Association

Fred W. Hoffmeyer, President
Imperial-Yuma Production Credit Association and
Federal Land Bank Association of El Centro

J. Allen Akkerman, President
Visalia Production Credit Association and
Federal Land Bank Association of Visalia

Type: Bookletter
Section Number: BL-014
Section Title: Government Seizure of Property Used in Connection with Controlled Substances
Old/Additional ID: (Original # 321-OE)

March 19, 1992

To: The Chief Executive Officer
All Farm Credit Institutions

From: David C. Baer, Director
Office of Examination

Subject: Government Seizure of Property Used in Connection with Controlled Substances

Under various authorities, law enforcement agencies may seize, and cause to be forfeited, real property and improvements which are obtained with the proceeds of activities or which are used in any manner to facilitate violations committed in connection with controlled substance offenses. Conveyances which are used or intended for use in any manner to facilitate the transportation of controlled substances are also subject to seizure and forfeiture. These activities are permitted by several Federal, State, or local laws and are governed principally by the Drug Abuse Prevention and Control Act, the Controlled Substances Act, and the Comprehensive Crime Control Act. Although enforcement is often connected with conveyances, authority exists to seize liened real property or chattels held by lenders, including Farm Credit System institutions.

Specifically, 21 U.S.C. 881 provides forfeiture authority for particular subject property. Paragraph (a)(7) provides that the following is subject to forfeiture to the United States: "All real property, including any right, title, and interest (including any leasehold interest) in the whole of any lot or tract of land and any appurtenances or improvements, which is used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, a violation of this title punishable by more than one year's imprisonment, except that no property shall be forfeited under this paragraph, to the extent of an interest of an owner, by reason of any act or omission established by that owner to have been committed or omitted without the knowledge or consent of that owner." In relation to possible chattels, the statutes provide that all conveyances, including aircraft, vehicles, or vessels, which are used, or are intended for use, to transport, or in any manner to facilitate the transportation, sale, receipt, possession, or concealment of controlled substances, are subject to seizure and forfeiture.

The "innocent owner" concept, included in the quoted portion of section 881, provides an avenue of relief from forfeiture to a lienholder. The lienholder institution seeking to judicially protect its innocent owner status must establish that the act giving rise to the seizure was committed without the lending institution's knowledge or consent nor at any time did it have any reason to believe that the property was being or would be used in a violation of the law. Altogether, the guidelines for exercising the innocent owner defense are rather stringent.

Any Farm Credit System institution encountering situations where collateral may be involved with possible illegal controlled substance offenses should contact the U.S. Attorney's office where the property is located. An important course of action for judicially protecting a lender's innocent owner status is prompt and cooperative communication with law enforcement agencies. Each institution is encouraged to begin a dialogue with its local U.S. Attorney's Office to establish procedures that can be used to protect the institution's innocent owner status.

All seizures of property should also be promptly reported to the appropriate FCA examination field office.

Please contact Robert Coleman at (703) 883-4231 if you have any questions.

Type: Bookletter
Section Number: BL-018
Section Title: Disclosure of Farm Credit Administration Reports of Regular Examination to Small Business Administration with Application for Approved Lender Status
Old/Additional ID: (Original # 391-OE)

June 21, 1994

To: Chairman, Board of Directors
The Chief Executive Officer
Each Farm Credit Bank
Each Production Credit Association
Each Agricultural Credit Association
Each Federal Land Bank Association
Each Federal Land Credit Association

From: Billy Ross Brown, Chairman
Farm Credit Administration Board

Subject: Disclosure of Farm Credit Administration Reports of Regular Examination to Small Business Administration with Application for Approved Lender Status

The purpose of this bookletter is to inform you of a recent action taken concerning disclosure of Farm Credit Administration (FCA) reports of regular examination (reports) to the Small Business Administration (SBA) in connection with application for approved lender status under the SBA's guaranteed loan program.

FCA reports are the property of the FCA and may be disclosed only with the consent of the Chairman of the FCA Board. The FCA has in the past approved the release of reports to the SBA for Farm Credit System institutions (FCSIs) on a case-by-case basis when needed as part of the application for approved lender status under the SBA's guaranteed loan program. In response to a number of recent requests from several FCSIs for permission to release reports to the SBA, the FCA Chairman has granted conditional consent to release regular examination reports to the SBA solely for use in qualifying FCSIs as approved lenders.[1] The FCA and the SBA have enter into a written agreement concerning the limited use of these reports (copy attached). Each FCSI that provides a report to the SBA must maintain documentation to substantiate that the SBA returned the report to the FCSI following completion of the application for approved lender status.

The consent for disclosure is conditioned on compliance with these conditions. Release of reports to SBA without complying with the conditions imposed by this bookletter and the agreement is a violation of 12 CFR 602.205.

If you have any questions, please call Jerry Erickson, Policy Development and Planning Division, at (703) 883-4231.

Attachment

[1] This consent applies only to FCA reports of regular examination and does not apply to reports of special examination. Any consent to disclose reports of special examination will be handled on a case-by-case basis.

AGREEMENT BETWEEN FARM CREDIT ADMINISTRATION BOARD AND SMALL BUSINESS ADMINISTRATION

Whereas, pursuant to 5 U.S.C. § 552(b), 12 U.S.C. §§ 2243, 2252, and 2254, and 12 C.F.R. § 602.205 and 602.289, Reports of Examination of Farm Credit System institutions made by the farm Credit Administration (FCA) are exempt from disclosure by the FCA; and

Whereas, in order for the Small Business Administration (SBA) to confer approved lender status on certain Farm Credit System institutions (institutions), it is necessary to make reports of regular examinations of the institutions (Reports) available to the SBA.

Now therefore, in the interest of assuring the confidentiality of the Reports, it is agreed that the Reports will be made available to the SBA on the following terms and conditions:

1. The SBA shall use the Reports of the examination of a particular institution and the information contained therein only for the purpose of designating that institution as an approved lender under the SBA's guaranteed loan program. The SBA agrees not to photocopy or quote directly from such Reports.

2. The SBA shall maintain the Reports as confidential documents of the FCA to the extent permitted by law and shall not disclose the Reports, which remain FCA property, or the information contained therein without the prior written approval of the FCA. If the SBA receives a request for the disclosure of the Reports or any of the information contained therein, the SBA shall promptly notify the FCA of the request so that the FCA can assert any exemptions, privileges, or objections.

3. Once the SBA has finished using the Reports of the examination of a particular institution for the purpose set forth in #1 above, the SBA agrees to return the Reports directly to that institution.

Dated this 8th day of June, 1994.

FARM CREDIT ADMINISTRATION BOARD

By: ________________________________
Billy Ross Brown, Chairman

SMALL BUSINESS ADMINISTRATION

By: ________________________________
John R. Cox
Associate Administrator for Financial Assistance

Type: Bookletter
Section Number: BL-020
Section Title: Leasing Authority of Farm Credit Banks and Agricultural Credit Banks Operating Under Title I, and Direct Lender Associations
Old/Additional ID: (Original # 404-OE)

December 22, 1994

To: Chairman, Board of Directors
The Chief Executive Officer
Each Farm Credit Bank
Each Agricultural Credit Bank
Each Production Credit Association
Each Agricultural Credit Association
Each Federal Land Bank Association
Each Federal Land Credit Association

From: Marsha Martin, Chairman
Farm Credit Administration Board

Subject: Leasing Authority of Farm Credit Banks and Agricultural Credit Banks Operating Under Title I, and Direct Lender Associations

In recent months, the Farm Credit Administration (FCA) has addressed several issues concerning leasing programs administered by Farm Credit institutions. The purpose of this bookletter is to provide clarification of the statutory leasing authorities of Farm Credit Banks (FCBs), and Agricultural Credit Banks (ACBs) operating under Title I, and direct lender associations operating under Title II.

Farm Credit banks and associations derive their leasing authorities from the lending provisions of the Farm Credit Act of 1971, as amended (Act).

From time to time, there has been some confusion over whether leasing falls under a Farm Credit System (System) institution's lending authority or its authority to provide financially related services. This situation is partly due to the location of FCA regulation § 618.8050 under part 618. At this time, the FCA is clarifying that the System's leasing powers are derived from the lending provisions of the Act.

Sections 1.11(c)(2) and 2.4(b)(4) of the Act grant Farm Credit banks and associations, respectively, express leasing powers. The structure of the Act and its legislative history reveal that leasing is a separately enumerated power that supplements the lending authorities of FCBs, ACBs, and associations, not a financially related service pursuant to sections 1.12 and 2.5 of the Act. Leasing provides eligible borrowers with other options for financing the acquisition of facilities and equipment through either financing or operating leases.

The lending and leasing authorities are subject to the same requirements concerning: (1) the scope of financing; and (2) activities conducted outside an institution's chartered territory pursuant to 12 CFR 614.4070. Furthermore, FCBs, ACBs, and associations may enter into lease transactions only with eligible borrowers who are bona fide farmers, ranchers, or aquatic producers or harvesters because of the statutory and regulatory requirement that the equipment or facilities leased must be needed in the lessee's operations.

Leasing authorities of Federal Land Credit Associations (FLCAs) are not the same as those of Production Credit Associations (PCAs).

When FCBs were created, they inherited separate and distinct leasing authorities from their constituent Federal Intermediate Credit Banks and the Federal Land Banks. As a result, FCBs and ACBs are authorized to make: (1) equipment leases pursuant to their short- and intermediate-term lending authorities; and (2) facility leases pursuant to their long-term real estate lending authorities. Under section 7.6 of the Act, an FLCA assumes its transferor bank's authority to make and participate in only long-term real estate loans; therefore, it is only authorized to make long-term facility leases. The Federal Land Bank Associations have no express leasing authority.

The PCAs, under section 2.4(b)(4), are authorized to make only short- and intermediate-term equipment leases. The PCAs and FLCAs may operate joint equipment leasing programs as long as the PCA is the lessor or holds title to the leased assets in its name, and records all lease transactions on its balance sheet. The ACAs have authority to make both long-term facility and short- and intermediate-term equipment leases.

Stock purchase is required by statute for some, but not all, leases.

Section 1.11(c)(2) authorizes FCBs to lease facilities and equipment to "persons eligible to borrow"; whereas, section 2.4(c)(4) of the Act authorizes PCAs to lease equipment to "stockholders." Based on these authorities, the FCA has determined that stock purchase is not required for facility leases. With regard to equipment leases, stock purchase is required for those leases made by a PCA or ACA, but not those made by an FCB or ACB.

The minimum stock purchase requirement contained in section 4.3A(c)(1)(E) applies only to "loans." For this reason, each PCA or ACA may determine the class and amount of stock that it will require for equipment leases. A PCA or ACA may require equipment lessees to purchase only a single share of stock provided that the association continues to meet its minimum permanent capital level under section 4.3 of the Act. Such stock requirements must be included in the institution's capitalization bylaws.

The lending limit applies only to financing leases.

Under FCA regulations in subpart J of part 614, financing leases must be included in the lending limit calculations of each System institution. Similarly, financing leases are treated as loans for the purpose of calculating Farm Credit System Insurance Corporation insurance premiums. Operating leases, which are ordinarily reported as fixed assets on an institution's balance sheet, should not be included in lending limit or insurance premium calculations.

Further basis for distinguishing between the two leases rests with their tax treatment. Rental payments under an operating lease are fully tax deductible to the lessee.[1] A financing lease qualifies as a conditional sale under the Internal Revenue Code. Under such a lease, the lessee is permitted to deduct interest payments and depreciation on the equipment.

Those institutions that have addressed leasing in their financially related services and technical assistance policies should make the appropriate changes. In making such changes, FCBs will not be required to resubmit their policies to the FCA for prior approval.

If you have any questions, please call Charlotte Miller, Policy Development and Planning Division, at (703) 883-4483.

Copy to: CoBank-National Bank for Cooperatives
Springfield Bank for Cooperatives
St. Paul Bank for Cooperatives

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[1] For tax purposes, an operating lease complies with the following requirements: (1) the lessor must expect to derive a profit from the transaction; (2) the lessee may not lend funds to the lessor to acquire the leased property, or guarantee the lessor's debt; (3) the lease should expire before the end of the economic life of the leased property so that the lessor's investment in the equipment remains at risk; (4) lease payments must amortize only the value of the equipment consumed during the lease term; (5) at the end of the lease, the lessee may not have the right to purchase the equipment for less than its fair market value; and (6) the lessee is not allowed to furnish any of the cost of the leased property, and the lessor cannot accept down payments or trade-ins.

Type: Bookletter
Section Number: BL-023
Section Title: Guidelines for Utilizing Derivative Products
Old/Additional ID: (Original # 425-OE)

October 31, 1995

To: The Chief Executive Officer
All Farm Credit Banks
Federal Farm Credit Banks Funding Corporation

From: David C. Baer, Director
Office of Examination

Subject: Guidelines for Utilizing Derivative Products

This Bookletter[1] sets forth the Farm Credit Administration's (FCA) views on the use and management of derivatives by Farm Credit institutions (FCIs). It also provides detailed guidance for FCIs to use as they establish or review systems for controlling risk. While this guidance is oriented for use by Farm Credit banks, any FCI engaged in the use of derivative products is expected to manage them in a safe and sound manner and will be subject to evaluation by examiners based on the attached criteria. If managerial or operational systems are found to be insufficient, the FCI may be required to modify its systems, increase capital, or take other protective actions.

Derivative products are financial contracts that derive their value from the performance of other instruments, indexes, or relationships. Examples include interest rate swaps, futures, options, forward rate agreements, and structured financings. When managed properly, derivative products can be efficient, powerful financial tools that enhance stability of business operations. They also can allow money managers the opportunity to structure an institution's balance sheet to help achieve desired objectives in almost any economic environment. Within the Farm Credit System, derivatives have been used to reduce borrowing costs, improve liquidity, manage basis and prepayment risks, improve investment returns, and achieve specific asset/liability management objectives.

The significant increase in the types of complex derivatives, the various conditions that affect their value, and the continually evolving derivative market present considerable risk to derivative users. Failing to understand, identify, and manage such risk can have a sudden and significant impact on an institution's financial position. Using derivatives for speculative purposes, such as placing leveraged bets on the future direction of financial markets or the purchase of structured notes[2] without regard to § 615.5132, Investment Purposes, increases their risk. The FCA considers any speculative use of derivatives an unsafe and unsound banking practice.

The use of financial derivative products requires special expertise, experience, and rigorous controls. The FCA expects critical management systems to be in place and should be employed commensurate with each institution's use of derivative products. FCIs using derivatives, or planning to do so in the future, should use the attached guidance in establishing or reviewing their derivative operations. Controls and management systems should be updated as new technologies are developed or changes in an FCI's activities cause current systems to become obsolete.

Please direct your questions on the subject of this document to Gregory Yowell, Senior Financial Analyst, Accounting and Examination Policy at (703) 883-4371 or contact the FCA field office assigned to examine your institution.

Attachment

Copy to: Chief Executive Officer
All Farm Credit Associations
All Farm Credit System Service Organizations

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[1] This Bookletter replaces FCA's August 27, 1990, Bookletter 265-OE, entitled "Guidelines for Interest Rate Swaps."

[2] As used, the term structured notes refers to investments with complex derivative-based features. These instruments include, for example, step-ups, index-amortizing or dual-indexed notes, and leveraged or range bonds. Structured notes are normally considered inappropriate for liquidity reserve purposes. Further, structured notes should not be used for any investment purpose unless management can demonstrate the MIS capabilities, controls, and expertise needed to evaluate and hold the security.

GUIDELINES FOR USE OF DERIVATIVE PRODUCTS BY FARM CREDIT SYSTEM INSTITUTIONS

The following guidelines and expectations will be used by examiners in evaluating a Farm Credit institution's (FCI) use, planned use, and management of derivative products. This document should be used by FCIs in establishing or reviewing their derivative operations. The guidelines are a complement to and should be read in conjunction with:

1. FCA Investment Regulations (as they apply to derivative products);
2. FCA Regulation 12 CFR 615.5135, "Management of Interest Rate Risk";
3. FCA January 15, 1991 Bookletter 281-OE, "Asset/Liability Management Practices"; and
4. FCA *Examination Manual*: Financial Module, Asset/Liability Management (ALM); Asset Module, Investments; and, Management Module, Internal Controls.

BOARD OF DIRECTOR RESPONSIBILITIES

The board of directors' role related to derivatives is to ensure the FCI's derivative activities are appropriate to its operations and risks are limited to prudent levels. Derivative programs need to begin with active involvement of the board of directors in establishing policies that delineate appropriate program controls and limits. The board needs to formally approve, as part of its ALM policy, a section addressing the use of derivative products, allowable risk parameters and tolerances, and controls/management systems for derivative activities. This section of the policy should be reviewed and updated as needed, but in any event, at least annually, by the board to ensure the following are addressed properly:

1. The scope of the FCI's planned involvement in derivatives and the authorized purposes for using derivatives.

2. A clear delineation of the responsibilities for managing the derivatives program and associated risks.

3. Expectations for risk management systems and measurement techniques. Expectations for both should be consistent with the nature, size, and complexity of the derivative portfolio.

4. Limits for portfolio makeup, instrument maturities, credit risk, and the level of earnings and capital at risk.

5. Controls and monitoring and reporting requirements needed to achieve compliance with approved policies.

At the time of the annual policy review, boards and management should discuss thoroughly the risks associated with the allowed derivatives and how each derivative product will be used. Utilization of derivative products where the type or purpose is not addressed in the policy should not occur at significant levels until comprehensive evaluation provides the board, senior management, risk management, legal, and accounting personnel full understanding of the associated risks and benefits.

Board members should discuss an FCI's derivative activities on a regular basis with senior management and other appropriate personnel. To facilitate discussion, each board should receive quarterly reports from the FCI's Asset/Liability Management Committee (ALCO) describing the institution's current derivative activities. Data reported to the board should be presented in an easily understandable and summary manner. The information should include discussions of derivative portfolio performance and variances from established guidelines. Submissions should also provide explanations and plans for resolving identified variances or concerns.

SENIOR MANAGEMENT RESPONSIBILITIES

Senior management must ensure appropriate procedures, management systems and expertise are in place for conducting derivative operations in accordance with board policy. Through procedures and management systems, senior managers must ensure that all significant risks arising from derivative transactions are quantified, monitored, and controlled.

Management also should ensure existence of a documented process for evaluating derivatives. This process should include sufficient detail to allow a third party to determine if the objectives, advantages, and risks of derivatives were identified before approvals were given and positions booked. The process also should document the performance of significant derivative positions taken and provide for routine reporting of results to an FCI's ALCO and its board of directors.

Staffing—One of management's most important responsibilities is to ensure FCI staff possess the expertise necessary to understand and identify the risks and benefits associated with derivatives. FCIs may rely on external experts for a portion of these skills, but must have sufficient internal skills to provide effective controls and oversight. Finally, compensation programs for staff dealing with derivatives should not be structured to encourage speculative activities.

Internal Controls—Controls are a joint responsibility of the board and senior management and should be sufficient to ensure compliance with relevant laws, regulations, policies, and procedures. Key controls must provide for the preventive detection of **unauthorized** transactions to ensure that only **authorized** transactions take place. Controls also must ensure that risk management and measurement systems are operating effectively and that management information systems are providing reliable and timely reporting and analysis. The appropriateness of each aspect of an FCI's management controls will be considered by examiners in the context of the materiality of the risk posed to the FCI by its use or planned use of derivatives.

As a further control, appropriate separation of duties within an FCI's derivative operations must exist. In particular, those individuals responsible for measuring, monitoring, and controlling risk should be independent of individuals who execute derivative transactions. Responsibilities for processing and verification of payment requests, cash management, margin calls, and collateral requirements should be assigned to individuals independent of those responsible for executing derivative transactions.

FCIs using derivative products should have this activity audited at least annually by qualified internal auditors. Also, the board should consider using external evaluation services to ensure derivatives are being appropriately managed.

Management Information System (MIS)—Management must ensure that FCIs have sophisticated MISs that (1) capture necessary data, (2) process transactions, (3) identify and track existing risks, (4) project risks under differing economic scenarios, and (5) monitor performance and compliance with existing policy and procedural constraints. On a transactional basis, the MISs should be sufficient to (1) allow staff to monitor hedge ratios, (2) calculate and verify margin requirements, (3) monitor the effectiveness of transactions, (4) compute net credit exposures and market valuations, (5) determine if existing positions need to be adjusted or terminated, (6) handle settlements, (7) track collateral, and (8) calculate the final results of actions taken.

MANAGEMENT OF RISKS ASSOCIATED WITH DERIVATIVE INSTRUMENTS

The types of risks associated with other financial activities also apply to the use of derivative products. Each of the risk areas discussed below should be addressed by FCIs using derivatives.

Interest Rate Risk (IRR)

Interest rate risk management is one of the principal purposes for which FCIs use derivative products. Prior to using derivatives, FCIs need to (1) define the level and types of IRRs that exist in their balance sheet, (2) analyze and understand what causes these risks, (3) measure the impact these risks may have on projected earnings and market values under a variety of possible scenarios, and (4) establish objectives for proposed actions to manage risks. FCIs must then monitor actions taken to ensure the purposes for which they were intended continue to be met.

Credit Risk

Credit risk is the prospect of failure by a counterparty to perform on an obligation to another institution. Credit risks are a particular concern for derivatives not traded on established exchanges. Credit limits for all derivative counterparties, which take into account the aggregate of all credit exposures to a particular counterparty, should be established by personnel who have credit expertise and are independent of money desk operations. The FCI's MIS should provide management with information concerning credit exposures in relation to current limits. FCIs are encouraged to utilize master agreements with netting provisions and bicollateralized swap agreements, as appropriate, to reduce credit risk. Finally, assets pledged as collateral in a derivative transaction cannot be counted as part of the FCI's liquidity reserve, nor may they be used to collateralize the issuance of Systemwide debt.

Legal Risk

Legal risk is the risk that contracts are not legally enforceable. This risk can be significant in over-the-counter derivative contracts. FCIs are responsible for ensuring that (1) contracts with counterparties are legally enforceable, (2) the terms of the agreement are legally sound and properly documented, (3) counterparties have the legal authority to engage in the transaction being considered, and (4) the FCI entering the transaction understands the terms of derivative commitments. It is strongly encouraged that any master agreements related to derivatives undergo legal review prior to execution.

Liquidity Risk

Liquidity risk, as it relates to derivatives, is the risk that an institution will be unable to execute a transaction at a reasonable price. Liquidity risk typically arises when credit risk exposure to a counterparty requires an FCI to liquidate or offset a particular derivative position. When reacting to control the liquidity risk, FCIs then become subject to associated market risks impacting the value of the affected derivative or the cost of the derivative needed for an offset position. The degree of market risk is aggravated when an inadequate primary or secondary market exists for the derivative subject to liquidation or offset. FCIs using derivatives should be aware of the size and depth of the markets corresponding to its derivative portfolio and establish appropriate limits and controls to address liquidity risk. Further, the inclusion of early termination or collateral clauses in derivative contracts should be reviewed for impact on liquidity.

Operational Risk

Operational risk arises when an institution fails to take appropriate action due to deficiencies in its management systems, internal controls, or understanding of the terms of a derivative product. It is imperative that FCIs have the operational expertise, internal controls, processing capabilities, financial resources, and management information systems necessary to successfully conduct derivative programs. It is essential that operational units accurately capture all relevant details of transactions, identify errors, and provide management with sufficient information to monitor risk exposures in a timely manner. FCIs also should have emergency contingency plans in case primary systems become inoperable.

Derivative transactions are normally consummated by the telephone. FCIs should consider the advantages of making audio recordings of these transactions to the extent permitted by law. FCIs always should ensure that supporting written confirmations are obtained. Trade tickets also should be completed at the time derivative transactions occur. Tickets should document the date and time of the trade, whether it was a buy or sell, the type of instrument being utilized (including its terms and conditions), the quantity bought or sold, the transaction price, the broker or counterparty, and a description of the trade's purpose.

Type: Bookletter
Section Number: BL-027
Section Title: Loan Participation Requirements
Old/Additional ID: (Original # 438-OE)

March 27, 1996

To: The Chief Executive Officer
All Farm Credit Institutions

From: William L. Robertson, Acting Director
Office of Examination

Subject: Loan Participation Requirements

Several Farm Credit System (FCS or System) institutions have raised questions about the scope of their authorities to participate in loans and leases under various provisions of the Farm Credit Act of 1971, as amended (Act).[1] In response, this Bookletter provides FCS institutions with specific guidance about: (1) the application of the independent credit requirements in § 614.4325(e) to the purchase of participation interests and other interests in pools or portfolios (hereafter referred to as pools) of loans;[2] (2) the authority of FCS banks and associations to participate with non-FCS lenders in loans to similar entities under sections 3.1(11)(B) and 4.18A of the Act; and (3) lease participation authorities of FCS lending institutions and service organizations that are chartered under section 4.25 of the Act.

I. How does the "independent credit judgment" requirement in § 614.4325(e) apply when an institution purchases an interest in a pool of loans from other FCS institutions or non-FCS financial institutions?

The independent credit judgment requirement of § 614.4325(e) applies equally to an interest in a single loan or a pool of loans.[3] The FCA recognizes that loan participation interests can effectively diversify loan concentration risk within an institution's portfolio.[4] However, loan participation interests expose System institutions to other types of risks. Although these risks can be managed, FCS institutions must be aware of such risks, and take them into consideration when they decide whether to purchase a participation or other interest in such loans.

The following passage from the preamble of the proposed regulation explains the FCA's reasons for requiring FCS institutions to conduct an independent credit analysis and reach an independent credit judgment when they purchase participation or other interests in loans:

> [T]he purchase of participation interests or other interests in loans without adequate independent analysis to make an independent objective decision by the purchasing institution on the borrower's creditworthiness and the quality of the asset is an unsafe and unsound practice. . . . The FCA believes that these requirements are necessary to the effective discharge of the [purchasing institution] board's fiduciary responsibility to the institution's stockholders to ensure that adequate internal controls are in place to safeguard its assets.[5]

The ultimate responsibility for the solvency of each System institution rests with its board of directors. For this reason, § 614.4325(e) requires the board of each FCS bank and association to independently: (1) analyze the institution's exposure to various risks associated with the purchase of a participation interest or other interest in either an individual loan, or a pool of loans; and (2) decide whether or not the purchase of the interest in question furthers the business goals and risk management objectives of the institution. Under § 614.4325(e), the board's accountability for such decisions cannot be delegated to a lead lender, agent, or other intermediary because such decisions directly impact the individual institution's solvency and viability.[6]

A. Does § 614.4325(e) require System banks and associations to exercise an independent credit judgment on every individual loan in a pool of loans?

No. Section 614.4325(e) requires an institution to exercise its independent credit judgment on any transaction to purchase a participation interest or other interest in an individual loan or pool of loans. However, § 614.4325(e) provides an FCS institution with the flexibility to conduct a due-diligence analysis on a sample of loans in a pool in which the institution will purchase a participation interest or other interest. Such a due-diligence analysis should be based on safe and sound underwriting criteria consisting of a composite evaluation of credits through the use of appropriate techniques. The FCS institution must be able to justify its assumptions when it relies on such composite evaluation techniques. The analysis also should include an evaluation of the originator, lead lender, servicing agent, or other intermediary's management capabilities, underwriting policies, and servicing procedures. In addition, when an interest in a pool of loans is originated to conform with, or is purchased under, a common set of underwriting criteria, such as a credit scoring system, the analysis may involve a review of the underwriting criteria, together with a reasonable sampling of the loans sufficient to ensure the consistent application of the criteria.

B. Are there situations when a due diligence analysis of a sample of loans in a pool of loans will not satisfy the requirements of § 614.4325(e)? If so, when is a heightened level of review and analysis required for a pool of loans?

Although System institutions are authorized to perform a due-diligence analysis on a sample of loans in a pool, every institution is also expected to conduct a separate, in-depth analysis of any loan(s) in the pool that could significantly increase the institution's exposure to a material risk of loss. As a result, each System lender is expected to assess its own vulnerabilities to loss, and decide when a pool of loans, or any portion thereof, merits a higher level of scrutiny commensurate with the institution's risk-bearing and management ability.

As an example, each System bank and association purchasing a participation interest or other interest in a pool of loans would be expected to conduct a separate analysis of individual loans that have characteristics concerning size, terms, conditions, or the nature of the borrower's enterprise that are significantly different from the majority of loans in the pool. To the extent that such individual loans pose greater risks of loss, prudence requires that the purchasing institution conduct an analysis of these individual loans separately from its due-diligence analysis on a composite sample of the rest of the loans in the pool.

Similarly, an institution's risk of loss also may increase if it acquires an interest in a pool of loans that is substantially dissimilar and requires different expertise than management of its own portfolio of loans. In such situations, an FCS institution may not be familiar with the risks inherent in certain types of credit, therefore, the institution should apply a greater degree of review and analysis to the purchase of such participations making sure that the associated risks are properly identified and addressed.

In addition, a higher level of review and analysis would be required if the purchase price of the interest of any of the individual loans within the pool equals a material portion of the System institution's capital. In contrast, a due-diligence analysis of a composite sample of loans in a pool would normally satisfy the requirements of § 614.4325(e) if the FCS institution purchases an interest in a pool of small loans that, in the aggregate, equals a material portion of the institution's capital.

C. Does § 614.4325(e) prohibit an FCS lender from delegating any decisions about the credit to a lead lender, agent, or intermediary?

No. The FCA has previously acknowledged that certain functions and decisions pertaining to credit administration may be delegated to a lead lender, agent, or other intermediary. The following passage in the preamble to the final regulation explains the FCA's position on the delegation of authority to outside parties:

> The final regulation grants the participants some discretion to delegate, by contract, certain judgments or servicing actions to either the lead lender or an agent. The final regulation does not require all participants in a loan to review decisions on nonsubstantive matters. The FCA considers certain servicing actions, such as granting time extensions for certain reporting requirements, releasing non-material portions of collateral, or granting a reasonable forbearance for meeting defined financial covenants, as nonsubstantive in nature. . . . Nevertheless, the FCA continues to believe that each participant must independently review and agree to any action which substantively alters either the terms of the loan or the participant's interest therein.[7]

As noted earlier, the subject of agent relationships and delegated authorities, by the institution to such agents, is addressed in more detail in the proposed Loan Underwriting regulations, which were adopted by the FCA Board at the March 12, 1996 Board meeting.

II. How do the "similar entity" authorities in sections 3.1(11)(B) and 4.18A of the Act expand the authority of System banks and associations to participate in loans with non-FCS lenders?

The Farm Credit Banks Safety and Soundness Act of 1992[8] and the Farm Credit System Agricultural Export and Risk Management Act[9] granted System banks and associations new authorities to participate in loans originated by non-System lenders. These new statutory authorities have expanded the loan participation authorities of System lenders in two ways. First, the definition of "participation" differs for loans to (1) eligible borrowers and (2) similar entities. Section 614.4325(a)(4) defines "participation" in a loan to an eligible borrower as "a fractional undivided interest in the principal amount of a loan. . . ." However, sections 3.1(11)(B)(iv) and 4.18A(a)(1) ("similar entity" authorities) of the Act define "participation" in a loan to a similar entity more broadly as "multilender transactions, including syndications, assignments, loan participations, subparticipations, or other forms of the purchase, sale, or transfer of interests in loans, other extensions of credit, or other technical and financial assistance," which may consist of a fractional divided interest in the loan. Second, the "similar entity" authorities authorize FCS banks and associations to participate in loans to borrowers who would not be eligible to borrow directly, provided that the ineligible borrower has operations that are functionally similar to the operations of eligible borrowers.

In addition, the "similar entity" authorities of the Act impose three restrictions on participation interests by FCS banks and associations in loans to similar entities: (1) the total amount of credit that a System institution has outstanding to a single credit risk shall not exceed 10 percent (or such higher limit as authorized by FCA and approved by the institution's shareholders) of its total capital; (2) the "similar entity" authorities sections of the Act require that the participation interest(s) of one or more FCS institutions in the same loan cannot equal or exceed 50 percent of the principal amount of the loan at any time; and (3) the Act limits the amount of participation interests in similar-entity loans that each FCS bank or direct lender association may hold at any time to 15 percent of its total outstanding assets.

On September 11, 1995, the FCA proposed § 613.3300 to implement the similar entity provisions of the Act. *See* 60 FR 47103 (Sept. 11, 1995). As proposed, § 613.3300 would not permit an FCS lender that operates under title I of the Act to participate with a non-System lender in a loan that a title II institution could make directly to the borrower, and vice versa. The comment letters about proposed § 613.3300 indicate that some FCS institutions disagree with the FCA's interpretation of the Act, while other System institutions support it. The FCA is carefully considering the comments of all parties.

A. Is the "similar entity" status of a loan participation interest determined by the eligibility of the borrower or the lending authorities of the FCS institution? For example, could a Farm Credit Bank (FCB), or a Federal Land Credit Association (FLCA) participate with a commercial bank in a short- or intermediate-term loan to a borrower who is eligible to borrow directly from a production credit association (PCA)?

"Similar entity" status is determined by the characteristics of the borrower, not the lending authorities of the lender. Section 4.18A(a)(2) of the Act defines a "similar entity" as a person who (1) is not eligible for a loan from either a Farm Credit bank that operates under title I of the Act or a direct lender association; and (2) has operations that are functionally similar to a person who is eligible to borrow directly from such bank or association in that the entity derives most of its income from, or has most of its assets invested in, activities that are permissible for eligible borrowers. In other words, a similar entity is an ineligible borrower who requires financing for a purpose which a System lender is authorized to finance.[10]

If the entity is eligible to borrow from either a Farm Credit bank that operates under title I of the Act or a direct lender association, it is not a similar entity for any other title I or II lender, and the purchase of participation interests in loans to such borrowers is governed by sections 1.5(12)(C) and 2.4(a) of the Act, respectively, rather than section 4.18A. In addition, specific participation authorities for the various types of FCS institutions are addressed in part 614, subpart A of the FCA's regulations. Accordingly, participation in a loan to an eligible borrower must consist of a fractional undivided interest, and the loan terms must be compatible with the institution's lending authority.

As an example, an FCB or FLCA could not purchase from a non-System lender a participation interest in a short- or intermediate-term loan that a PCA could make directly to an eligible borrower.[11] Similarly, a PCA could not directly purchase a participation interest in a long-term mortgage loan from a non-System lender.[12]

B. Do the "similar entity" authorities of the Act enable FCS banks and associations to purchase from non-System lenders interests in loans, other than fractional undivided interests, to eligible borrowers?

No. Section 4.18A does not expand the authority of an FCS lending institution to participate with non-System lenders in loans that such System bank or association could make directly to the borrower. As a general rule, System banks and associations lack authority to purchase from a non-System lender whole loans and interests (other than fractional undivided interests) in loans to eligible borrowers.[13]

III. Can a service organization chartered under section 4.25 of the Act, such as the Farm Credit Leasing Services Corporation (FCLC), sell lease participation interests to FCS banks and direct lender associations and, conversely, can such FCS banks and associations purchase lease participation interests from such service organizations?

Yes. As an FCS service organization chartered under section 4.25 of the Act, the FCLC has the same authorities, subject to limitations in its charter and articles of incorporation, as its parent institutions,[14] except that it cannot extend credit or sell insurance.[15] Therefore, despite the absence of any specific direction in subpart A of part 614 of the regulations pertaining to the FCLC's ability to purchase or sell participation or other interests in leases, section 4.25 of the Act authorizes the FCLC to participate in or sell and purchase interests in leases to the same extent as its parents. However, the FCLC cannot purchase or sell participation interests or other interests in loans because the Act prohibits such section 4.25 service organizations from extending credit to FCS borrowers.

In addition, System banks and direct lender associations are authorized by the Act and FCA regulation to sell to and purchase from other FCS institutions participation interests and other interests in loans and similar credits.[16] Therefore, FCS banks and associations are authorized to sell to and purchase from service organizations, such as the FCLC, participation interests and other interests in leases. The FCLC may also purchase from and sell to non-System institutions fractional undivided interests in leases to the extent of their parents' authority.

The FCA, with this Bookletter, has attempted to address some of the significant issues that have arisen pertaining to loan participation activities and participation authority issues related to the FCLC and other FCS institutions' leasing activities. However, there are other issues related to loan and lease participation activities that will require further analysis by the FCA. Such issues include: (1) lending limits and territorial concurrence for leases; (2) capitalization requirements; and (3) out-of-territory activities pertaining to leasing, loan participation, and the purchase and sale of loan interests. In addition, this Bookletter does not address whether service organizations that are chartered under section 4.25 of the Act are authorized to engage in similar entity transactions. These additional issues will be dealt with in future bookletters or regulatory revisions.

If you have any further questions on these matters, please contact Dennis Carpenter, Senior Policy Analyst, at (703) 883-4256.

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[1] For the purpose of this Bookletter only, the term "Farm Credit System institution" refers exclusively to System banks and associations.

[2] Proposed § 614.4325(a)(1) would revise the definition of "interests in loans" to expressly include transactions involving a pool of loans. *See* FCA Board Action on Loan Underwriting Proposed Rule (BM-12-MAR-96-03).

[3] *See* 57 FR 38237, 38241 (Aug. 24, 1992).

[4] According to § 614.4325(a)(4), "participation interest" refers to a fractional undivided interest in the principal amount of any loan that a lead lender sells to a participating lender.

[5] See 56 FR 2452 (Jan. 23, 1991). The FCA reaffirmed this position in the preamble to the final regulations. See 57 FR 38237 (Aug. 24, 1992).

[6] Proposed § 614.4325 provides clarification and additional direction pertaining to the delegation of specific transaction authorities to agents. (See FCA Board Action on Loan Underwriting Proposed Rule (BM-12-MAR-96-03).

[7] *See* 57 FR 38237 (Aug. 24, 1992).

[8] Pub. L. No. 102-552, § 502, 106 Stat. 4130 (Oct. 28, 1992).

[9] Pub. L. No. 103-376, § 2, 108 Stat. 3497 (Oct. 19, 1994).

[10] See 60 FR 47103, 47115 (Sept. 11, 1995). However, section 4.18A(b)(4) of the Act expressly precludes System banks that operate under title I of the Act and direct lender associations from participating in rural housing loans under their similar entity authorities.

[11] One method for FCS institutions to facilitate such "eligible borrower" participation with a non-System lender would involve a PCA or agricultural credit association (ACA) serving as an intermediary, purchasing the participation interest from the non-System lender and then selling a participation interest to the FCB or FLCA. Similarly, a FCB, FLCA, or ACA would have to purchase an interest in a long-term mortgage loan and then sell an interest to the PCA.

[12] Under sections 3.1(11)(B) and 4.18A of the Act, however, a party who is eligible to borrow from a title III lender may qualify as a similar entity for a System institution that operates under titles I or II of the Act, and vice versa. The definition of "participation" in sections 3.1(11)(B)(iv) applies to such transactions because, for example, the eligible title III borrower is a similar entity for the title I or II lender that is participating in the loan. Furthermore, the Act imposes consent requirements when a title I or II lender participates with a non-System institution in a loan to a similar entity that is eligible to borrow directly from a title III bank, and vice versa.

[13] Farm Credit banks operating under title I of the Act and direct lender associations may only purchase certain qualified mortgage loans to eligible borrowers and interest therein from non-System lenders when they are pooling and securitizing loans for the Federal Agricultural Mortgage Corporation (Farmer Mac) pursuant to their respective authorities under sections 1.5(24), 2.2(21) and 2.12(22) of the Act.

[14] Section 209 of the Farm Credit System Reform Act of 1996 (Pub. L. No. 104-105, 110 Stat. 162 (Feb. 10, 1996)) added a new section 4.28A, which revises the definition of "bank" in section 4.25 to include "each association operating under title II" of the Act.

[15] Section 4.25 of the Act states that a Farm Credit bank or group of banks can organize a service corporation for the purpose of performing functions and services for or on behalf of the organizing banks " . . . **Provided**, that a corporation so organized shall have no authority either to extend credit or provide insurance services for borrowers from Farm Credit System institutions, nor shall it have any greater authority with respect to functions and services than the organizing bank or banks possess under this Act. . . ."

[16] FCA regulations at § 614.4325(a)(3) define loans as any extension of credit or similar financial assistance of the type authorized under the Act, such as leases, guarantees, letters of credit, and other similar transactions.

Type: Bookletter
Section Number: BL-030
Section Title: Voluntary Advance Conditional Payment Accounts
Old/Additional ID: (Original # 445-OE)

April 17, 1996

To: Chairman, Board of Directors
The Chief Executive Officer
All Farm Credit System Institutions

From: Marsha Martin
Chief Executive Officer

Subject: Voluntary Advance Conditional Payment Accounts

The Farm Credit Administration (FCA) has noted an increasing use of voluntary advance conditional payment accounts (VACPs) by System institutions. Sections 1.5(6) and 2.2(13) of the Farm Credit Act of 1971, as amended, authorize institutions to accept advance payments. FCA's regulations at 12 C.F.R. 614.4513(a) establish the general guidelines for VACPs. This bookletter conveys the safety and soundness considerations that will govern the FCA's examination of VACP policies and practices.

As the term VACP suggests, an institution may only hold these funds as an advance payment for a shareholder who has an outstanding loan or commitment from that institution. The amount of the loan or commitment from the institution limits the amount that can be placed in a VACP. For long-term mortgage loans, the VACP balance may not exceed the outstanding balance on the related loan(s). With proper documentation, a short-term lender may accept funds up to the amount of the borrower's outstanding line of credit or loan commitment. Commitment amounts should be based on sound underwriting standards and either the historic or reasonably projected borrowing needs to the borrower during the current operating cycle. The VACP balance should be at or below the projected maximum outstanding loan balance for related loans using a revolving line of credit.

FCA regulations provide that an institution may provide funds to the borrower from a VACP in lieu of increasing the borrower's loan. Institutions must manage VACPs to avoid liquidity risk, however. Acceptable approaches include retaining discretion for the timing of the release of funds, requiring adequate advance notice from borrowers, or limiting the aggregate amount of VACPs to the amount of available unused funding under the general financing agreement or other approved funding source. The interest rate paid on VACPs should consider the potential cost of replacing withdrawn funds from another source and the contract rate on the related loan.

An institution that accepts VACPs should have policies adopted by its board that provide guidance to management for VACP administration and that require periodic reporting to the board in sufficient detail to monitor VACP practices. Administrative guidance should address interest rates paid and any effect on asset/liability management, the documentation requirements for the size of the VACPs that are related to loan commitments, any limitations on the size or frequency of withdrawals, and other internal controls. Policies should require written agreements with borrowers and adequate disclosures regarding:

1. The fact that funds in the VACP are uninsured and an explanation of the risk in the event of liquidation of the institution;
2. Limits on amounts that can be paid into VACPs;

3. Interest rates that will be paid, including the terms of variable interest rates; and
4. Withdrawal guidelines or restrictions.

Because VACP funds are to be applied to outstanding loan balances, these funds generally should be accounted for as contra-assets. However, if the borrower's access to VACP funds is not restricted, amounts should be recorded as liabilities. Also, if the VACP is based on a loan commitment, any amount in excess of the related loan balance should be recorded as a liability.

During examinations of System institutions holding VACPs, the FCA will evaluate the institutions' VACP policies, procedures, and practices. If instances of inappropriate practices are identified, corrective action could include requiring that VACP balances be returned to the affected borrowers.

Questions regarding this bookletter should be directed to me at (703) 883-4007 or Terry Stevens, Office of Examination, at (703) 883-4483.

Type: Bookletter
Section Number: BL-036
Section Title: Farm Credit Administration's Approval Requirements for the Global Debt Program
Old/Additional ID: (Original # 463-OE)

August 30, 1996

To: The Chief Executive Officer
All Farm Credit System Banks

From: Marsha Pyle Martin
Chairman and Chief Executive Officer

Subject: Farm Credit Administration's Approval Requirements for the Global Debt Program

The Farm Credit Administration (FCA) has approved the Federal Farm Credit Banks Funding Corporation's (Funding Corporation) request to authorize the Funding Corporation to issue, on behalf of Farm Credit System (FCS or System) banks, global debt denominated in either U.S. dollars or foreign currencies. FCA's approval of the System's Global Debt Program (GDP) establishes criteria under which FCA will consider each System bank's request to issue global debt. This bookletter transmits a copy of the GDP approval and clarifies FCA's expectations regarding the issuance of foreign currency denominated debt (FCDD).

- Prior to requesting FCA approval to issue FCDD, each System bank should review and, if necessary, amend policies and procedures to ensure currency and counterparty risks are appropriately managed, monitored, and reported. FCA will evaluate each System bank's policies and procedures for monitoring, managing, and reporting counteparty and currency risk as part of the ongoing examination process. Based in this evaluation, FCA may deny a bank's request to issue FCDD. In evaluating policies and procedures, FCA examiners will expect the following:

- Each bank should establish policies and procedures that address currency risk. Examiners will expect policies to establish the maximum amount and maturity of FCDD that can be outstanding in any one currency and should incorporate country risk ratings. FCA's approval of the GDP establishes minimum country risk ratings that must be observed in each bank's policies and procedures.

- FCA's approval of the GDP requires that simultaneous with the issuance of FCDD, System banks, or the Funding Corporation on the banks' behalf, must execute a cross-currency swap to U.S. dollars that matches the underlying FCDD. Although FCA does not require that the Funding Corporation execute the cross-currency swap on behalf of the bank, procedures and controls must establish coordination with the Funding Corporation to ensure that the swap terms are consistent with the terms of the FCDD. On a case-by-case basis, FCA may approve issuance of FCDD that is not fully matched with a cross-currency if the FCDD obligation is used to offset other identified currency risk on the requesting bank's balance sheet. A bank requesting such approval should have procedures in place that clearly demonstrate and isolate the currency risks that are being hedged with the FCDD.

- FCA examiners will expect policies and procedures to require that cross-currency swaps be only with bank board-approved counterparties. FCA's approval of the GDP includes minimum credit ratings for cross-currency swaps that should be consistent with or incorporated into each bank's policies and procedures.

- Board policies should establish maximum counterparty exposure limits. The exposure limits should be based on the consolidated counterparty exposure for all derivative products (e.g., interest rate swaps, basis swaps, options, cross-currency swaps, etc.) and investments. Banks may wish to differentiate the exposure limits based on the credit rating of the counterparties and/or by whether or not the counterparty is subject to a collateralization agreement.

- Each bank's policies and procedures must address monitoring and reporting of counterparty risk. FCA examiners will expect banks to monitor both the current exposure position and peak (or potential) exposures under clearly defined stress tests. Peak exposures should be measured on a consolidated counterparty basis for all derivative products (e.g., interest rate swaps, options, cross-currency swaps, etc.) and investments. Each bank's procedures should include trigger points based on the peak counterparty exposures that would either limit further transactions with the counterparty and/or provide for implementation of strategies to reduce the peak exposure. Although banks may establish dollar exposure limits, FCA suggests that limits be expressed as percentages of permanent capital, total net worth, or unallocated surplus.

- Each bank's policies and procedures should address the impact of bi-collateralization agreements on the bank's free collateral position. FCA examiners will expect each bank to be able to compute, monitor, and report the peak (or potential) amount of collateral that the bank must pledge to counterparties under clearly defined stress tests and the impact such peaks will have on the bank's free collateral position. Each bank's procedures should include trigger points based on peak pledged collateral positions that would either limit further transactions and/or provide for implementation of strategies to reduce the peak pledged collateral.

- Each bank's policies or procedures should address the frequency of monitoring reports. FCA examiners will expect the bank's procedures to require more frequent monitoring of counterparty exposures and collateral positions in times of greater volatility and/or when the bank is approaching its established limits.

- Each bank must adopt appropriate policies and procedures for the accounting and reporting of transactions involving the issuance of FCDD. The FCA expects such policies and procedures to conform with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 52, Foreign Currency Translation, and other authoritative literature governing the accounting and disclosure of transactions involving foreign currencies.

- Each bank's policies and procedures should be adequately supported. FCA examiners, for example, will expect the bank to be able to support the reasonableness of policies and/or procedure limits and guidelines.

Each System bank that anticipates issuing FCDD should review and, if necessary, amend its policies and procedures with the above expectations in mind. Prior to requesting FCA formal approval to issue FCDD, each bank is encouraged to consult with its local examination office to ensure that FCA examiners are fully informed and early communication occurs relative to program criteria as outlined in this bookletter.

If you have any questions or concerns with FCA's expectations or approval of the GDP, please contact either your local examination office, me, Jim Enzler or Andrew Jacob of FCA's Office of Examination at (703) 883-4483.

Attachment

FARM CREDIT ADMINISTRATION APPROVAL OF GLOBAL DEBT PROGRAM

The Farm Credit Administration (FCA) approves the Federal Farm Credit Banks Funding Corporation's (Funding Corporation) request to authorize the Funding Corporation to issue, on behalf of the Farm Credit banks, debt securities (global debt) under a Global Debt Program (GDP). Any changes to this approval require FCA Board action. As requested by the Funding Corporation, the GDP is limited to $5 billion in outstanding issues. FCA approval is subject to the GDP meeting the following FCA debt issuance conditions:

I. **FCA approval process for global debt issuances.** FCA's approval process for global debt issuances will distinguish between U.S. dollar denominated debt and foreign currency denominated debt (FCDD) as follows:

A. FCA will consider specific approval requests for U.S. dollar denominated debt issuances on a monthly shelf basis identical to the current medium term note (MTN) program.

B. The FCA will consider specific approval requests for FCDD issuances on a monthly shelf basis solely to facilitate timely action on investor inquiries (reverse inquiries), where the deal includes common FCDD terms, matching cross-currency swap to U.S. dollars, and final maturity of the FCDD does not exceed 5 years. Common debt terms are fixed rate, simple floating rate, callable, simple step-up, or amortizing securities.

C. FCA will consider individual prior-approval requests for all other FCDD issuances including reverse inquiries where the deal involves unique debt terms or unique variations of common debt terms. Any issuance with a maturity greater than 5 years, regardless of any optional redemption features, shall require FCA Board approval. Unique debt terms include complex floaters, specialized indexed, or other exotic structures such as inverse floaters, range floaters, stock indexed, exchange rate indexed, or complex step-up securities. If the Funding Corporation is uncertain of whether an individual or shelf approval is appropriate, it should contact the FCA. The banks' requests for approval of an FCDD issuance must include a draft term sheet and swap dealer confirmation listing the specific terms and conditions of the transaction.

Consistent with the MTN approval process, FCA may, at any time, require individual prior-approval requests for specific banks or types of securities. The Funding Corporation should provide the FCA with as much advance notice as possible of issuances under negotiation, particularly of FCDD issuances.

II. **Evaluation of risk management systems.** FCA will evaluate each Farm Credit System (System) bank's process for monitoring, managing and reporting counterparty and currency risk as part of the ongoing examination process. Based on this evaluation, FCA may deny a bank's FCDD funding request.

III. **Simultaneous swap of currency risk.** Simultaneous with the issuance of any FCDD security, System banks, acting in concert with the Funding Corporation, must execute a cross-currency swap(s) to U.S. dollars that fully matches the underlying FCDD. On a case-by-case basis, banks may request FCA approval to not fully match the foreign debt with a cross-currency swap if the FCDD obligation is used to offset and match other currency risks on the requesting bank's balance sheet. The cross-currency swap counterparty must be prior approved by each System bank's board.

IV. **Cross-currency swap counterparty credit rating requirement.** Counterparties to cross-currency swaps are limited to those counterparties considered to have an "upper-medium" credit rating. FCA defines an "upper-medium" rating as meeting at least two of the following: Moody's rating of A1 or better; Standard and Poor's rating of A or better; International Bank Credit Analysis, Inc. rating of A or better; and Thompson rating of B or better. Further, FCA requires System banks to obtain collateralization agreements for cross-currency swap counterparties that are rated below a "high" credit rating by a nationally recognized rating service. FCA defines a "high" rating as meeting at least two of the following: Moody's rating of Aa2 or better; Standard and Poor's rating of AA- or better; International Bank Credit Analysis, Inc. rating of AA- or better; and Thompson rating of A/B or better. A collateralization provision requires the swap counterparty to post collateral with a safe keeping agent when the net mark-to-market of all swap transactions exceeds a certain dollar threshold. Each System bank should negotiate reasonable thresholds as a function of the credit quality of the counterparty.

V. **Country risk rating requirement.** Issuances of FCDD are limited to currencies of countries with at least a Moody's sovereign country rating of Aa2 or a Standard and Poor's country foreign currency debt rating of AA.

VI. **Funding Corporation reporting to FCA.** The Funding Corporation will provide FCA a weekly detailed report of all issues under the GDP. The report should be consolidated with the weekly report on the MTN program and should include all global debt, MTN debt, unscheduled bond sales, and any swaps executed in conjunction with the debt issues.

VII. **Annual report on Global Debt Program.** Annually, the Funding Corporation must provide an analysis of the results of the GDP. The analysis should include the financing (including spread relationships) and operational costs of the GDP.

Recommended for Approval by:

Financial Analysts: ______________________________

James E. Enzler and Andrew D. Jacob

Acting Director, Office of Examination:

William L. Robertson

Recommendation is hereby approved:

Marsha Pyle Martin
Chairman and Chief Executive Officer
Farm Credit Administration

Type: Bookletter
Section Number: BL-037
Section Title: Lending Policies and Loan Underwriting Standards Regulations
Old/Additional ID: [Old/Additional ID]

October 28, 1997

To: Chairman, Board of Directors
Chief Executive Officer
Each Farm Credit Institution

From: Marsha Pyle Martin
Chairman and Chief Executive Officer

Subject: Lending Policies and Loan Underwriting Standards Regulations

The Farm Credit Administration (FCA) Board recently granted final approval for regulations on Lending Policies and Loan Underwriting Standards that are included in 12 CFR 614.4150. This bookletter clarifies the approach and expectations that FCA will use to examine compliance by Farm Credit System institutions (institutions) with these regulations.

The newly promulgated regulations provide flexibility so institutions may tailor lending policies and loan underwriting standards in accordance with safe and sound business practices commensurate with the needs and capability of the institution and its members. Although these regulations eliminated the requirement that System lenders obtain a verifiable balance sheet and income statement from most borrowers at least annually, institution boards and management should remain cognizant of the responsibility to obtain current and reliable financial information on borrowers as needed to properly measure and manage risks within the loan portfolio, and determine the allowance for losses.

Institution boards should avoid practices resulting in conditions that existed prior to 1985 when many institutions were unable to accurately assess risk because they did not have and were unable to obtain current financial information from borrowers. The need for current financial information on borrowers becomes even more crucial to appropriately evaluate risk and the institution's safety and soundness as conditions change in the lending environment or as conditions change under which loans were originally made. Therefore, in accordance with sound business practices, institutions will be expected to incorporate into borrower loan agreements (or any other legally binding instrument executed with the borrower at the time of loan closing) the requirement that borrowers provide at any time during the duration of the loan current, reliable, and verifiable financial statements (balance sheets and income statements) as requested by the lender subsequent to loan closing. This requirement should also be incorporated into legal instruments for lending programs that do not require verifiable or signed financial statements from borrowers at the initiation of a new loan. The failure of an institution to make provisions to obtain such financial information from the borrower upon request of the lender, or the failure to obtain current, reliable, and verifiable financial information from borrowers when conditions worsen in individual loans, segments of the loan portfolio, or the loan portfolio in its entirety, could be considered by FCA examiners as an unsafe and unsound practice that would require corrective action by the institution's board of directors.

The regulations prescribe, in general, the contents expected in lending policy and loan underwriting standards. FCA examiners will review board policies and procedures to determine that loan underwriting standards are established and implemented for all lending programs that the institution plans to offer. The institution's lending standards should be incorporated into such policies or procedures and establish the minimum credit and financial information required from borrowers. In considering this requirement, each institution should determine the frequency needed for the collection and verification of credit and financial information, commensurate with the risk in the loan and the type of credit extended, that will enable the institution to be kept apprised of the borrowers' operating performance or risk inherent in the loan. Accordingly, each institution's loan underwriting standards should include measurable standards to determine that the applicant has the operational, financial, and management resources to repay the debt from cash flow, and provide guidance on requiring collateral and other security as may be needed to ensure full collection of the debt in accordance with the terms established in the promissory note or other loan agreements.

The board of each institution should clearly prescribe its delegations of approval authority on loans, including delegations of authority to approve exceptions to underwriting standards. There should also be a process established for reporting to the board those actions taken under the authority delegated. Each institution should have internal control systems capable of monitoring compliance with loan underwriting standards and reporting exceptions to the institution's board and/or management.

The institution's underwriting standards should result in loans with acceptable risks, both on an individual basis and collectively as an entire portfolio. The FCA examiners will consider an acceptable level of risk as being risk which is commensurate with the institution's capital protection and management's ability to control risk. In this respect, the board of each institution should ensure that its loan underwriting standards are appropriate for the risk-bearing capacity of the institution within tolerances established by the board. Concentrations (whether they be by industry, loan size, or any other specialization) should be adequately measured and managed to limit the excessive exposure of capital to risk inherent in such loan portfolio segments. The board should also ensure that internal controls identify lending practices that may cause excessive risk or practices that threaten the financial condition of the institution so that prompt corrective actions can be taken.

Lending practices and loan underwriting standards should be reviewed periodically by board and management to ensure they appropriately preserve and strengthen the soundness and stability of the institution's financial condition and performance and are compatible with the lending environment. Such reviews for example, should take into consideration: planned actions within the context of the institution's strategic business plan to enter new market segments; changes in the economic, business, and lending environments; changes in government policies; changes in the institution's financial condition and risk bearing capacity; changes in principal credit personnel; and other factors that might change in those operating conditions under which the loan underwriting standards were established.

While each of the issues as discussed in this letter provides direction that will be considered in measuring compliance with 12 CFR 614.4150, each institution's board has the ultimate responsibility and fiduciary duty to ensure the institution operates in a safe and sound manner. Additional guidance in this area can be obtained by reviewing the FCA publication entitled The Director's Role. Copies of that publication are available from the Office of Congressional and Public Affairs, FCA, 1501 Farm Credit Drive, McLean, Virginia 22102-5090.

If you have any further questions on these matters, please contact me or Roland E. Smith, Chief Examiner, at (703) 883-4160.

Type: Bookletter
Section Number: BL-038
Section Title: Guidance Relating to Investment Activities
Old/Additional ID: [Old/Additional ID]

November 26, 1997

To: The Chief Executive Officer
All Farm Credit System Banks
Federal Farm Credit Banks Funding Corporation

From: Marsha Pyle Martin
Chairman and Chief Executive Officer

Subject: Guidance Relating to Investment Activities

The Farm Credit System (Farm Credit) banks requested that the Farm Credit Administration (FCA) provide interpretative guidance concerning provisions of the investment management regulations in subpart E of part 615 and authorize new investments pursuant to § 615.5140(a)(11). The FCA has also received requests to revise certain provisions of the regulations so that Farm Credit banks will have greater flexibility to adapt to the continuing evolution of the financial markets.

This bookletter provides additional guidance to Farm Credit banks on the scope of their authorities under existing regulations to invest in mortgage-backed securities that are backed by mortgages that convert from a fixed-rate to an adjustable-rate, bank notes, and general obligations of State and municipal governments. In addition, this guidance provides an interpretation on whether Farm Credit banks are authorized to acquire hedge instruments that raise or remove the cap on floating-rate collateralized mortgage obligations and clarifies the liquidity reserve requirements in § 615.5134.

Petitions for change, various developments in the securities markets, improvements in risk management technologies, and modifications in the other financial regulators' approaches to managing risks in securities activities have also contributed to the need to reassess FCA's investment regulations. Thus, as noted in the Unified Agenda of Federal Regulations, the FCA Board plans to consider a rulemaking to revise the investment regulations during the spring of 1998. The proposed rulemaking will address issues beyond those included in this guidance.

A. Fixed/Floating Adjustable-Rate Mortgage Securities

Farm Credit banks are currently authorized by § 615.5140(a)(2) to invest in securities that are backed by either fixed-rate mortgages or adjustable-rate mortgages (ARMs) that satisfy certain conditions. According to § 615.5140(a)(2)(ii), eligible securities may be backed by ARMs that have repricing mechanisms of 1 year or less tied to an index.[1] Additionally, fixed-rate mortgage-backed securities (MBSs) that comply with the three-pronged test in § 615.5140(a)(2)(iii) are eligible investments for Farm Credit banks.[2]

Farm Credit banks have inquired about their authority to invest in MBSs that are collateralized by ARMs that bear a fixed-rate of interest for 3 or 5 years, and then adjust annually pursuant to an index. These "fixed/floating ARMs" are commonly referred to as 3/1 and 5/1 ARMs. In recent years, fixed/floating ARMs have become an important segment of the MBSs market.

Fixed/floating ARMs are a hybrid of fixed-rate and adjustable-rate MBSs because they share common attributes with both types of securities. The FCA determines that § 615.5140(a)(2) authorizes Farm Credit banks to invest in MBSs that are collateralized by mortgages that bear a fixed-rate of interest for a specified number of years and then reprice annually. These MBSs must comply with the requirements of § 615.5140(a)(2)(iii) at the time of purchase and each quarter thereafter until the date of first repricing. Once these instruments begin to reprice every 12 months or less, they are subject to § 615.5140(a)(2)(ii), which governs adjustable-rate MBSs. This approach enables Farm Credit banks to invest in fixed/floating ARMs in a prudent manner.

B. Applicability of Hedge Instruments to the Farm Test

FCA regulation § 615.5140(a)(2)(iv) exempts floating-rate collateralized mortgage obligations (CMOs) from the requirements in § 615.5140(a)(2)(iii)(A) and (B) if interest rates remain below the contractual interest rate cap. Thus, floating-rate CMOs that bear interest rates below their contractual cap rate are only required to comply with the price sensitivity test in § 615.5140(a)(2)(iii)(C). The Farm Credit banks request that hedge instruments that are specifically purchased to raise or remove the cap on floating-rate CMOs should be considered along with the underlying CMOs for the purpose of determining whether the exemption in § 615.5140(a)(2)(iv) applies.

Purchasing hedge instruments that raise or remove the cap on floating-rate CMO investments is compatible with the risk management objectives of § 615.5140(a)(2)(iii). Such hedge instruments effectively counteract the risk that rates will rise above the embedded cap, thereby decreasing the price sensitivity of the floating-rate CMO to changing interest rates.[3]

For this reason, the FCA will permit Farm Credit banks to use hedge instruments to effectively raise or remove interest rate caps on floating-rate CMOs under the following conditions:

1. These investment activities comply with the requirements in FCA's bookletter (BL-023, October 31, 1995) concerning "Guidelines for Utilizing Derivative Products."

2. Farm Credit banks demonstrate that a hedge relationship exists between the hedge instruments and the underlying floating-rate CMO(s). Objectives for the hedge should be documented before the hedge instrument is purchased, and afterwards, Farm Credit banks should routinely monitor the performance of the hedge to ensure that these objectives are being met. Farm Credit banks should also be able to demonstrate that the hedge instrument can easily be sold in the event that the underlying CMO is liquidated.

3. Farm Credit banks maintain documentation that the hedge transaction makes sound economic and business sense and adhere to the investment objectives and risk limits of the bank and FCA regulations. Essentially, Farm Credit banks must demonstrate that the primary purpose of a hedge is to reduce the price sensitivity of the CMO to changes in interest rates, rather than to merely qualify the investment for exemption under § 615.5140(a)(2)(iv).

C. Investments in Bank Notes

The FCA has reviewed § 615.5140(a)(8), which permits investments in certain corporate debt obligations, and determines that Farm Credit banks may acquire bank notes under this provision. The FCA concludes that bank notes are compatible with the investment objectives in § 615.5132. Bank notes are senior unsecured debt obligations of commercial banks. Active markets exist for both short-term bank notes that mature within 1 year and medium-term bank notes that mature within 5 years.

Bank notes are not insured deposits under section 3(l) of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. 1813(l), and therefore, holders of bank notes are general creditors of the issuing bank. Bank notes are corporate debt obligations of commercial banks. For these reasons, the FCA determines that Farm Credit banks may purchase and hold bank notes pursuant to their authority under § 615.5140(a)(8) to invest in corporate debt obligations that:

1. Maintain a credit rating of at least "AA" or its equivalent.
2. Mature within 5 years or less from the date of purchase.
3. Qualify as marketable investments pursuant to § 615.5131(j).
4. Do not convert into equity securities.

In accordance with § 615.5140(a)(8), corporate debt obligations cannot exceed 15 percent of each Farm Credit bank's investment portfolio. Additionally, § 615.5140(b) prohibits Farm Credit banks from investing more than 20 percent of their total capital in eligible investments of a single obligor.

When Farm Credit banks acquire bank notes that mature within 1 year or less, they may rely on the short-term ratings assigned by any nationally recognized statistical rating organization (NRSRO). For the purpose of § 615.5140(a)(8), the FCA considers a short-term rating of "A-1" equivalent to a "AA" long-term rating.[4]

D. Full Faith and Credit Obligations of State and Local Governments

The following discussion provides Farm Credit banks with guidance relating to the scope of their authorities under §§ 615.5140(a)(10) and 615.5140(a)(11) to invest in revenue bonds that are issued by State and local governments.

For the purposes of § 615.5140(a)(10), full faith and credit obligations are issued by a State or local government (including duly constituted governmental authorities that provide education, water and sewer, hospital, and public transportation services within a specified territory) that possesses powers of general taxation. In this context, the State or local government is obligated to repay its debt with proceeds from income, sales, or property taxes. Other sources of revenue, such as fee income for governmental services or payments from the Federal government, may provide a credit enhancement for general obligation bonds that are issued on the full faith and credit of a State or local government. Additionally, full faith and credit obligations of State and local governments are eligible investments for Farm Credit banks under § 615.5140(a)(10) if they: (1) maintain at least a rating of "A" or its equivalent by a NRSRO; (2) mature within 10 years from the date of purchase; and (3) qualify as marketable investments under § 615.5131(j).

Revenue bonds are debt obligations of local governments that are repaid from sources of income other than tax revenue, such as fees or transfer payments from the Federal government. Revenue bonds, however, may still qualify as full faith and credit bonds under § 615.5140(a)(10) if another obligor with general powers of taxation (including property taxation) has unconditionally promised to make funds available to cover all payments on such obligations. For example, if fee income is the only source of revenue for a governmental authority that operates public airports, its revenue bonds are not eligible investments under § 615.5140(a)(10). However, if a State or local government which possesses general taxation powers unconditionally pledges to make funds available to cover all payments of the bonds issued by the airport authority, these debt obligations become eligible investments under § 615.5140(a)(10). Industrial revenue bonds do not qualify as full faith and credit bonds under § 615.5140(a)(10) because private-sector obligors, and not the governmental authority, are ultimately responsible for paying the investors.

The FCA believes revenue bonds that are not backed by general taxing powers of a governmental obligor are too diverse to be effectively covered by § 615.5140(a)(11). For this reason, the FCA continues to explore other regulatory approaches for these revenue bonds in its rulemaking activities.

E. Clarification of the Liquidity Reserve Requirement

Currently, § 615.5134(b) requires each Farm Credit bank to separately identify all investments that it holds in the liquidity reserve that it maintains pursuant to § 615.5140(a). In response to concerns expressed by Farm Credit banks, the FCA clarifies that the segregation requirement in § 615.5134(b) does not prevent Farm Credit banks from:

1. Shifting specific investments in or out of the liquidity reserve to effectively manage risks to the bank.

2. Using investments in the liquidity reserve for managing interest rate risk.

3. Maintaining liquidity reserves in excess of 15 days but not exceeding 30 percent of total outstanding loans.

As the FCA interprets § 615.5134(b), a Farm Credit bank has the flexibility, at any time, to decide which instruments in its investment portfolio will be allocated to the liquidity reserve that it maintains pursuant to § 615.5134(a). Section 615.5134(a) requires each Farm Credit bank to maintain sufficient liquidity to fund its operations for a minimum of approximately 15 days. Moreover, Farm Credit banks should be mindful that § 615.5132 prohibits Farm Credit banks from holding investment portfolios that exceed 30 percent of total outstanding loans, and it only allows Farm Credit banks to acquire investments for maintaining a liquidity reserve and managing short-term surplus funds and interest rate risk.

Please direct any questions you may have concerning this bookletter to Laurie A. Rea, Senior Policy Analyst at (703) 883-4498 or real@fca.gov.

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[1]The existing regulation enables Farm Credit banks to invest in securities that are backed by ARMs with repricing mechanisms based on the following indices: (1) 1-year Constant Maturity Treasuries (CMTs); (2) Cost of Funds Index (COFI) of the Federal Home Loan Bank for the Eleventh District; (3) 3- and 6-month Treasury bills; (4) certificates of deposit at selected commercial banks; or (5) the London Interbank Offered Rate (LIBOR).

[2]Section 615.5140(a)(2)(iii), commonly known as the Farm Test, establishes a three-pronged test for eligible collateralized-mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and fixed-rate MBSs. These instruments are eligible investments if at the time of purchase and each quarter thereafter: (1) the weighted average life (WAL) does not exceed 5 years; (2) the expected WAL does not extend for more than 2 years assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points, nor shorten more than 3 years assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points; and (3) the estimated change in price is not more than 10 percent assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

[3] The most common hedge technique employed to remove or raise an embedded cap is to purchase interest rate caps or a strip of caps on the index rate that is used to reprice the CMO floater. Farm Credit banks may

also use other hedge instruments, such as interest rate swaps or similar off-balance sheet instruments to accomplish the same objectives.

[4]"A-1" ratings are issued by Standard & Poor's Corp. Equivalent ratings by other NRSROs include "P-1" by Moody's Investors Service, "D-1" by Duff & Phelps, Inc., "F-1" by Fitch Investors Service, and "TBW-1" by Thomson Bankwatch, Inc.

Copy to: Chief Executive Officer
All Farm Credit Associations
All Farm Credit System Service Organizations

Type: Bookletter
Section Number: BL-040 REVISED
Section Title: Providing Sound and Constructive Credit to Young, Beginning, and Small Farmers, Ranchers, and Producers or Harvesters of Aquatic Products
Old/Additional ID: [Old/Additional ID]

August 10, 2007

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Nancy Pellett
Chairman and Chief Executive Officer

Subject: Revised Bookletter 040 - Providing Sound and Constructive Credit to Young, Beginning, and Small Farmers, Ranchers, and Producers or Harvesters of Aquatic Products

I. Purpose

This updated bookletter provides guidance on interpreting the phrase "sound and constructive credit," in § 4.19 of the Farm Credit Act of 1971, as amended (Act), as well as Farm Credit Administration (FCA or Agency) regulation 614.4165, on the young, beginning, and small (YBS) farmers and ranchers mission (YBS regulation) of the Farm Credit System (FCS or System). This interpretation is important to ensure that all System institutions are fully engaged and use all available authorities to assist YBS farmers, ranchers, and producers or harvesters of aquatic products (YBS farmers) to begin, grow, or remain in agricultural or aquaculture production. The bookletter also retains the definitions for all three categories, "young," "beginning," and "small" farmers.

II. YBS Mission

Section 4.19 of the Act requires System associations to establish programs for furnishing " . . . sound and constructive credit and related services to young, beginning, and small farmers and ranchers." The YBS regulation, which implements the Act's YBS provision, requires System direct-lender associations to include, in their YBS programs, minimum components to ensure that they can successfully fulfill their YBS mission.

All agricultural producers face a significant number of challenges, including access to capital and credit; the impact of rising costs on profitability; urbanization and the availability of resources, like land, water, and labor; globalization; and competition from larger or more established farms. However, the hurdles that YBS farmers face are even greater due to their lack of an agricultural production history, inexperience in production agriculture, low capital position, or limited credit history. The System's YBS mission is therefore crucial to enabling YBS farmers to begin, grow, or remain in agricultural production and to facilitate the transfer of agricultural operations from one generation to the next.

III. YBS Definitions

The following definitions are the same as those adopted by the Agency when this bookletter was originally issued, December 1998, with the exception of referring to young, beginning, and small *farmers* instead of *borrowers*. The categories remain separate and distinct, and a loan to one borrower may meet the definition for any or all of the categories, but a loan does not have to meet all three to be considered a loan to an YBS farmer.

Young farmer: A farmer, rancher, or producer or harvester of aquatic products who is age 35 or younger as of the loan transaction date.

Beginning farmer: A farmer, rancher, or producer or harvester of aquatic products who has 10 years or less farming, ranching, or aquatic experience as of the loan transaction date.

Small farmer: A farmer, rancher, or producer or harvester of aquatic products who normally generates less than $250,000 in annual gross sales of agricultural or aquatic products.

Additional direction on these definitions is included in the call report instructions provided by the Agency each year to all System institutions.

IV. Providing Sound and Constructive Credit to YBS Farmers

What is sound and constructive credit?
The agricultural operations of most YBS farmers require a significant amount of diversity in income and assets (a combination of agricultural and nonagricultural) for the total operation to remain viable. Therefore, to address the needs of this critical group of System borrowers, sound and constructive credit is defined as credit that is used by YBS farmers to begin, grow, or remain in agricultural production. Sound and constructive credit may include credit for nonagricultural as well as agricultural purposes.

Credit parameters for bona fide farmers
FCA regulation 613.3000(a)(1) defines a bona fide farmer as "a person owning agricultural land or engaged in the production of agricultural products . . . " FCA lending objective regulation 613.3005 envisions financing the full credit needs of full-time farmers, and more conservative agricultural credit and restrictive nonagricultural credit for less than full-time farmers. The regulation also envisions only agricultural credit for those bona fide farmers whose business is essentially other than farming.

Determining a YBS farmer's commitment to agricultural production
The degree to which an YBS farmer is engaged, or intends to be engaged, in agricultural production determines the type and amount of credit that is available to the borrower. System institutions should analyze each application to determine the applicant’s commitment to agricultural production and therefore the type and amount of agricultural and nonagricultural credit needed to begin, grow, or remain in agricultural production. Indicia of a borrower's commitment to agricultural production could include, but is not limited to, the following factors:

1. The degree of day-to-day involvement the borrower must have in the agricultural production operation, through either labor or management, or both, to evidence a clear commitment to agricultural production;
2. The intent of the borrower to actively engage in agricultural production, as evidenced by his education, training, experience, business plan or some other means;

3. A level or projected level of gross agricultural income or production that evidences a clear commitment to agricultural production; or
4. The terms and structure of the loan, as well as planned use of loan proceeds, evidence a commitment to be truly engaged in agricultural production.

The foregoing and other criteria should be applied and weighed in a manner that best allows a System institution to meet the unique circumstances of each YBS farmer. For example, an applicant's lack of ownership of agricultural assets may be offset by considerable experience as a farm manager with demonstrated production responsibilities, evidencing a commitment to agricultural production. This commitment may make him or her a strong candidate for credit under the institution's YBS lending program.

Credit enhancements for YBS farmers

One of the most significant challenges for many YBS farmers with little or no agricultural income or assets is complying with an association's traditional loan underwriting standards. Typically, YBS farmers often have a combination of little or no assets to pledge as collateral, little or no historical production records, and little or no on-farm management experience. To provide sound and constructive credit under the Act's YBS mandate, the YBS regulation, and within the general parameters of FCA's lending objective regulation at 613.3005, System lenders should consider creating a program of reasonable credit enhancements and credit coordination programs for this often less financially stable, yet crucial group of farmers. Credit enhancements could include applying more flexible interest rates or fees, underwriting standards, and collateral requirements on such loans, as well as obtaining guarantees, such as Farm Services Agency guarantees.

System lenders may also want to consider a YBS lending policy that treats a subset of part-time YBS farmers as bona fide, full-time farmers. The subset would consist of those farmers with a high degree of commitment to begin, grow, or remain in production agriculture operations and a demonstrated intent to progress toward agricultural production as their primary business and vocation. The phrase "primary business and vocation" is used in FCA's lending objective rule at 12 C.F.R. § 613.3005 to define a "full-time, bona fide farmer." It is up to each association to select a method for determining who meets the definition of a full-time farmer. The determination of full-time for this subset of YBS farmers will have to be made, in most cases, using qualitative rather than quantitative criteria. Qualitative criteria could include an applicant's education, training, experience, business plan, or some other means that evidences the YBS farmer's commitment or intent to progress toward production agriculture as his or her primary vocation. Whatever method is chosen to determine who may be treated as a "full-time" farmer, it is critical that System institutions base the method on reasonable criteria. We note that the USDA's Agricultural Resource Management Survey counts full-time farmers as those operators who report farming as their major occupation.

Providing these YBS farmers with all of the credit and services available to full-time farmers would be considered another type of credit enhancement. Generally, any credit enhancement that improves an YBS farmer's prospects for success in agricultural production will be considered reasonable. Nonetheless, System lenders should consider their risk-bearing capacity in determining whether a credit enhancement, or combination of credit enhancements, is reasonable for their institution.

Setting aside capital for the YBS mission

In order to provide for the types of credit enhancements needed to adequately serve the YBS markets (which typically pose more risk), System institutions should consider setting aside capital that they are willing to put at risk to support programs that meet the credit needs of these YBS farmers. The amount of capital made available should be based on the strength of the institution's financial position, risk management tools, and safety and soundness controls. The Agency recognizes that designating capital for

YBS lending will require considerable judgment by the System lender to ensure that it balances the credit needs of YBS farmers with the association's risk-bearing capacity.

Coordinating YBS credit with other entities
As required by § 614.4165(c)(3) and to reduce the risk associated with YBS programs, System lenders should consider increasing coordination with other System institutions, government agencies, and the private and public sectors to make use of all risk mitigation tools, such as state and federal loan guarantees or other such programs (both government or privately sponsored). Additionally, this regulatory section requires System lenders to develop outreach initiatives that could include, but are not limited to, using YBS advisory committees.

Sharing best practices
To ensure that all System institutions are implementing the most effective YBS programs possible, we encourage FCS institutions to share their best practices. This sharing of best practices is important to ensure that the System as a whole provides all YBS farmers the credit they need to begin, grow, or remain in agricultural production.

YBS farmers with minimal involvement in agriculture
The credit enhancements and capital designated for YBS programs are not intended to apply to those applicants *whose business is essentially other than farming.* As discussed in Agency guidance on *Other Credit Needs* in Examination Bulletin: FCA 2006-2, each System institution should include in their lending policies and procedures a reasonable definition of this phrase that could also apply to YBS borrowers.

V. YBS and Other Credit Needs Lending Policies

System institutions are strongly encouraged to review and modify their YBS policies and programs in response to the guidance in this bookletter. For example, System lenders may want to include in their YBS lending policies a description of the types of credit enhancements available to YBS farmers, as well as measurements and controls to ensure that the credit enhancements are applied to the suitable group of YBS farmers. Appropriately revised YBS policies would include:

- Expanding the criteria used to determine a full-time farmer to include those part-time YBS farmers with a demonstrated intent to progress toward farming as their primary business and vocation,

- A list of factors which must be documented in the loan file that will be used to demonstrate the YBS farmer's commitment or intent to progress toward agricultural production as his or her primary business and vocation (see indicia under *Determining a YBS farmer's commitment to agricultural production* above), and

- A set of internal controls, including an audit program, to ensure that its YBS policies and program are implemented for the benefit of YBS farmers to begin, grow, or remain in agricultural production.

The guidance in this bookletter also is intended to complement the guidance issued by the Agency on *Other Credit Needs* in Examination Bulletin: FCA 2006-2. Therefore, System institutions are also strongly encouraged to amend their *other credit needs lending* policies and programs to develop different criteria for determining the amount of *other credit needs* financing available to YBS farmers. Such criteria should take into consideration the factors used to determine the degree to which a YBS farmer is engaged, or intends to be engaged, in agricultural production.

VI. Examples

The following examples highlight how a System lender may implement the guidance in this bookletter. These examples illustrate the types of loans that would likely be consistent with a sound and constructive YBS program. To ensure that such credit remains sound, System institutions should consider supporting such loans through the use of at-risk capital set aside to serve the YBS market or through other risk mitigation tools.

1. **Facts:** A beginning farmer applies for a $45,000 loan to rent 300 acres of corn/soybean cropland. He works for a local corn and soybean farmer and has a written agreement with his employer to rent the equipment necessary to operate this acreage. He will also market his product with his employer. His goal is to use this acreage as a way of working toward becoming a full-time farmer. His loan application includes a business plan describing how he plans to grow his business. **Analysis:** This YBS farmer does not own any assets to pledge as security, however, he has considerable farming experience in the type of operation that he is proposing to begin and an educational background in agriculture. Thus, this farmer has a demonstrated intent to progress toward farming as his primary business and vocation. **Result:** The beginning farmer could be treated as a full-time farmer. The association may need to rely more heavily on the applicant's education and farming experience to make this loan. However, this loan would likely be consistent with a sound and constructive YBS program.
2. **Facts:** A recent college graduate with a degree in Animal Science applies for a $75,000 loan to rent land, purchase cattle, and for operating funds to begin a cattle operation. The applicant worked on a cattle ranch before and during college. She will also work for the local feed dealer in town. Her loan application included a business plan describing how she plans to grow the business. **Analysis:** This YBS farmer does not own any assets to pledge as security; however, she has both education and farm experience in the cattle ranching operations she is beginning. Thus, this farmer has a demonstrated intent to progress toward farming as her primary business and vocation. **Result:** The young and beginning rancher could be treated as a full-time YBS farmer. The association may need to rely more heavily on the applicant's education and farming experience to make this loan. However, this loan would likely be consistent with a sound and constructive YBS program.
3. **Facts:** A young farmer rents 200 acres of farmland, owns his equipment, and owns a welding shop located in a rural area. His gross farm income is $12,000 and gross income from the welding shop is $60,000. He requests a $200,000 loan to refinance his high-cost, long-term debt incurred when purchasing the welding shop. He would like to expand his agricultural production acreage, but first he needs to increase his cash flow by refinancing this high-cost debt. **Analysis:** This farmer has a demonstrated intent to progress toward farming as his primary business and vocation. The income from the welding shop is critical to the growth and success of the farm and, therefore, this loan contributes to the young farmer's ability to remain in agricultural production. **Result:** The young farmer could be treated as a full-time YBS farmer, and the loan would likely be consistent with a sound and constructive YBS program.
4. **Facts:** A small farmer operates a wheat and cattle operation. He rents all his land and equipment from his father and intends to take over and grow the operation as owner once his father retires. His spouse is a licensed dentist. They apply for $300,000 to purchase the local rural dental office. The income from this non-farm business is needed for the farmer to continue and grow his operation. **Analysis:** This farmer has a demonstrated intent to progress toward farming as his primary business and vocation. Financing this business enterprise helps both the YBS farmer diversify and grow his operation, and also helps the local rural area by continuing to provide local dental care. **Result:** The small farmer could be treated as a full-time farmer, and the loan would likely be consistent with a sound and constructive YBS program.

5. **Facts:** An applicant requests a $2 million loan from a System association to purchase agricultural land. He is classified by the association as a "beginning" farmer since this is his first purchase of agricultural land. While the property has the capacity to produce agricultural products, the borrower does not currently intend to engage in agricultural production. However, the borrower has sufficient ability to repay the loan with income generated by his nonagricultural business. **Analysis:** Although likely eligible for this System loan as a bona fide farmer due to his purchase of agricultural land, the indicia point to the conclusion that this borrower has not demonstrated intent to progress toward agricultural production as his primary business and vocation. **Result:** While this loan likely could be made, and other credit enhancements may be afforded by the association's sound and constructive YBS program, this beginning farmer should not be treated as a full-time farmer.
6. **Facts:** A small farmer requests $65,000 to purchase a 1.5 acre rural plot of land near a large metropolitan area and $1,000 in operating funds for inputs and equipment to grow fruits and vegetables. The applicant is an immigrant to the United States who works in construction and sells produce at farmers' markets on the weekends. He would like to grow his small farm business by purchasing small plots of land as he can afford them with the intention of moving out of construction except as needed to supplement his farm income. Produce sales currently bring in a modest annual income of approximately $5,000. **Analysis:** This farmer represents a growing trend in agriculture that is seeing immigrants getting into small and specialized agricultural production operations. Although currently the farmer is working in construction, he has demonstrated an intent to progress toward farming as his primary business and vocation through his serious commitment to agricultural production. **Result:** The small farmer could be treated as a full-time farmer, and the loan would likely be consistent with a sound and constructive YBS program.
7. **Facts:** A young and beginning farmer who has a small general law practice in a rural town requests a $150,000 term loan to begin a vineyard operation on the property owned by his parents – property that he will one day inherit – that is located in his community. The income from his small practice annually nets $45,000. He also requests a $30,000 term loan for improvements to the law practice. The applicant, who has been nurturing a serious interest in grape varieties, wines, vineyards, and wine regions for a number of years, intends to spend a portion of each day running the day-to-day operation. As his wine business grows, he intends to devote less and less time to his legal practice. His business plan, submitted with the loan application, describes how he intends to implement his vision of developing a successful and prestigious label that will offer a variety of red and white wines. **Analysis:** Although he his currently practicing law, this applicant has a demonstrated intent to progress toward farming as his primary business and vocation. The income from his law practice is critical to his entrance into the winemaking business, so providing him with financing for his legal needs as well as his agricultural needs will help him sustain and grow his winemaking operation. **Result:** The small and beginning farmer could be treated as a full-time farmer, and these loans would likely be consistent with a sound and constructive YBS program.

Type: Bookletter
Section Number: BL-043 REVISED
Section Title: Guidance on Farm Credit Bank and Association Nominating Committees
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September 13, 2018

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Dallas P. Tonsager
Chairman and Chief Executive Officer

Subject: Guidance on Farm Credit Bank and Association Nominating Committees

One of the most important contributions that a voting stockholder of a Farm Credit bank or association can render is serving as a member of his or her institution's nominating committee. It is through this service that member-owners actively influence their institution's commitment to good governance. The Farm Credit Administration (FCA) issued regulations at § 611.325 to address the use of nominating committees. FCA regulations §§ 611.320 and 611.340 also impact operations of the nominating committee.

This bookletter, through a question-and-answer (Q&A) format, provides guidance on organizing the nominating committees of Farm Credit banks and associations. It also provides guidance on a nominating committee's authority in selecting nominees for all open stockholder-elected director positions and the permissible activities of directors, officers, employees, and agents in working with nominating committees. FCA has also published a pamphlet, "The Role of Farm Credit System Nominating Committees," to help stockholders and prospective nominating committee members understand their responsibilities. We encourage System institutions to make the pamphlet available at all headquarters and branch offices. It is also available on FCA's Website at www.fca.gov.

Organizing a Nominating Committee

1. How are nominating committees formed?

FCA regulation § 611.325 requires each bank and association board of directors to establish and maintain policies and procedures on its nominating committee describing the formation, composition, operation, resources, and duties of the committee. Effective policies and procedures will also address items such as the number of committee members, selection of alternate members, the general eligibility requirements for committee membership, and committee duties in response to interim board vacancies. Although the policies and procedures will address certain aspects of nominating committee authorities, also having a nominating committee charter is a best practice. A charter normally outlines the recusal procedures, oaths of office, confidentiality requirements, quorums, and similar meeting requirements. The nominating committee may be structured in a manner to ensure geographic or commodity representation; however, the voting stockholders of that institution must be allowed to vote for every nominating committee position.[1]

2. Who is eligible to serve on a nominating committee?

While authorized representatives of a Farm Credit bank's[2] stockholder-associations serve on its nominating committee, only owners of voting stock at an association may serve on its nominating committee. This means that when a loan has more than one obligor, resulting in shared ownership of the voting stock, any one of those obligors may serve on the association's nominating committee. Further, the shared ownership of the voting stock means service on an association's nominating committee cannot be restricted to the obligor designated to cast the vote for all obligors on the loan. As an additional safeguard, only one of those persons sharing ownership of the voting stock may seek the opportunity and serve on the nominating committee within an election cycle. Generally, out-of-territory borrowers holding voting stock in an institution may serve on the nominating committee unless the institution has a bylaw provision prohibiting such service and written notice of the restriction was provided to the out-of-territory borrower at the time of loan closing. An employee, director, or agent of the institution may not be elected to, or serve on, that institution's nominating committee.

3. How are candidates for service on the nominating committee identified?

A nominating committee is a committee of voting stockholders acting on behalf of the System institution's stockholders. Election to the nominating committee is best treated as a competitive process in which stockholders may name themselves or other voting stockholders for election to the committee. Candidates for election to the nominating committee may also be identified from various methods, including by names submitted via an institution's Web site (when other means are available that do not require electronic access), telephone, voice mail, electronic mail, or other procedures. In addition, System institutions may, but are not required to, allow floor nominations of nominating committee candidates. Also, the current nominating committee may be given responsibility for identifying a list of candidates for service on the next nominating committee. Directors and management of the System institution should not name candidates for, or appoint members to, the nominating committee.

4. How is the election of nominating committee members conducted?

Voting stockholders of the institution must be provided the opportunity to cast a vote on every position on the nominating committee. Our rule at § 611.325(b) provides that associations may use either in-person or mail balloting procedures to elect nominating committees, whereas Farm Credit banks must use weighted voting, with no cumulative voting permitted. Voting procedure rules contained in FCA regulation § 611.340 are applicable when electing nominating committees.

5. How frequently are nominating committee members elected?

The nominating committees of associations are restricted to a duration of one year, after which a new committee must be formed. Generally, associations arrange to elect new nominating committees each year at their annual meetings. Associations may allow committee members to serve subsequent 1-year terms, but are encouraged to establish term limits for nominating committee members. The frequency of elections for nominating committee members at the Farm Credit banks is established in each bank's

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[1] If representational positions are structured into the committee, System institutions should ensure out-of-territory borrowers are "assigned" an area. Otherwise, out-of-territory borrowers would be restricted to "at-large" positions.

[2] CoBank, ACB, also has voting stockholders that are other than System associations and may, therefore, have nominating committee members that are representatives of the voting stockholder associations or other voting stockholders.

nominating committee policies, procedures, and bylaws. Farm Credit banks are not required to annually elect a nominating committee, nor limit committee membership to a one-year term.

6. May nominating committee members receive pay or reimbursement from the institution?

System institutions may adopt policies that allow paying nominating committee members a reasonable fee or provide repayment for actual expenses (e.g., travel related to committee meetings). System institutions considering such payments are encouraged to address how the pay is determined within written policies and to ensure that payments are provided in a nondiscriminatory manner to all committee members. These policies should also be established well in advance of the nominating committee's director-nominee selection activities to avoid the appearance of influencing the nominations.

Nominating Committee Duties and Authority

7. What is the primary duty of the nominating committee?

It is the responsibility of each nominating committee to identify, evaluate, and nominate candidates for stockholder election to a System institution's board of directors. The committee is expected to nominate at least two individuals for each board seat listed on the ballot. The nominated individuals are those whom the committee determines meet eligibility requirements to run for open director positions and best address desired director qualifications. The nominating committee should strive to nominate director-candidates representing its institution's borrowing base.

8. How does a nominating committee find two nominees for an open stockholder-elected director position?

Each nominating committee is to be provided a current list of stockholders in the institution. This stockholder list is the one described in § 618.8310(b). A nominating committee is expected to use the stockholder list and other resources to find willing director-candidates from all areas of the System institution's territory and, as nearly as possible, all types of agriculture practiced within the territory. If requested by the nominating committee, management may provide a list of the institution's advisory committee members or any other persons with grassroots connections to the institution from which the nominating committee may identify potential director-candidates. Also, institutions may allow use of their Web sites, telephone message center, or other similar resources to collect names of individuals interested in becoming directors.

9. What if a nominating committee is having trouble finding two nominees for an open stockholder-elected director position?

While at least two nominees for each open stockholder-elected director position is expected, it may not always be possible. In those situations, the nominating committee must provide a written explanation to the institution's board, describing the committee's efforts to find at least two willing director-candidates and the reason(s) for disqualifying any director-candidate. The institution then must include a summary of this explanation in the voting information provided to stockholders.

10. Who is eligible to serve as a stockholder-elected director?

At Farm Credit Banks, only authorized representatives from the stockholder-associations may serve as stockholder-elected directors.[3] At associations, only those owning voting stock in the association may

[3] CoBank, ACB has separate Title III authority regarding its board composition.

serve as stockholder-elected directors of that association. For joint or entity borrowers, any one of the obligors sharing ownership of voting stock in the association may, on behalf of all the stock's owners, seek election to the association's board. In joint stockowner situations, only one person acting on behalf of all the stockowners may serve on the board and that person is not restricted to the obligor designated to cast votes on behalf of the borrower. If an entity is the sole owner of the stock, then the entity must identify whom from its operation may seek election to the association's board on behalf of that entity. Preferably, the individual selected by the entity would hold a vested interest in the success of the association as well as the borrowing entity he or she represents.

11. What factors affect eligibility for service as a director?

The Act and FCA regulations set forth the following eligibility requirements for service on a System institution's board of directors:

a. No employee of an association, whether the owner of voting stock or not, may serve on the association's board of directors;
b. No person who was an employee or officer of either a Farm Credit bank or association within 1-year of the date when board service would begin may serve on the board;
c. No member of the nominating committee may seek election to the board during the same election cycle as the nominating committee is identifying director candidates;
d. No person who is legally incompetent may serve on a System institution's board of directors;
e. No individual may, without FCA consent, serve on a System institution's board of directors if that person has been convicted of any criminal offense involving dishonesty or a breach of trust; and
f. Out of territory borrowers holding voting stock in the association may serve on the association board of directors unless prohibited by the association's bylaws.

A System institution may have additional standards for service on its board of directors that are contained within its bylaws or part of its Director Qualifications Policy.[4] Eligibility and qualification standards apply to all persons seeking election to the board, including incumbents.

12. How does the nominating committee know whether a director-candidate satisfies the director eligibility requirements of the Act and FCA regulations?

FCA regulation § 611.330 requires director-nominees to disclose specific information regarding eligibility or face disqualification. This regulation, combined with § 611.320(e), creates the expectation that every director-nominee will self-certify as to eligibility for service. Institutions do not have to place the name of any director-nominee on the ballot who has failed to self-certify that he or she is eligible to serve as a director of that institution. Additionally, the nominating committee may remind director-candidates of eligibility requirements and qualification standards established by regulation or institution policy.

13. May the nominating committee access the institution's records on individual director-candidates?

A nominating committee is a committee of stockholders: it is not a board committee. As such, the nominating committee is not authorized access to information specific to a director-candidate that is not also available to all stockholders of the institution. In addition, FCA regulation § 618.8320(a) prohibits institution staff from revealing data regarding "the character, credit standing, and property of borrowers

[4] These additional standards may not violate law or regulations and should be designed to preserve the member-owned, member-controlled cooperative structure of the System.

and applicants for loans" absent a named exception. The nominating committee is not among the named exceptions in § 618.8320. Thus, nominating committees must not have access to protected information for any candidate or nominee.

14. When should nominating committee members recuse themselves?

The policies and procedures of the System institution should identify recusal situations and the process by which recusals are accomplished. Generally, nominating committee members would recuse themselves whenever their participation in committee activities presents a conflict of interest or the appearance thereof. For example, a nominating committee member who has a family member that is seeking election to the board may have to recuse him or herself from the nomination process. Recusals may leave the institution with fewer than the required minimum three committee members, so establishing alternate members or increasing the size of the committee beyond the minimum 3 members is encouraged.

15. Do incumbent directors seeking re-election go through the nominating committee process?

Incumbent directors are not exempt from the nomination process, nor may System institutions require their nominating committees to nominate incumbents. The nominating committee's task is to nominate those whom it decides best meets the needs of the stockholders, the board of directors, and the institution overall. Incumbent directors, when expressing interest in running for reelection, may either submit their own names to the nominating committee (in the same manner as other stockholders) or be nominated from the floor.

16. Do floor nominees for open director positions go through the nominating committee process?

Floor nominations are the only exception to the nominating committee process. However, FCA regulation § 611.326 provides that floor nominees must still satisfy director eligibility requirements and make the required director nominee disclosures of § 611.330 before voting takes place.

17. Does a nominating committee have a role to play when a board is downsized?

When an institution's board agrees to a downsizing plan, the plan must continue to provide for the election of at least one stockholder-director each year. It remains the responsibility of the nominating committee to select the nominees for any open elected stockholder-director position, and this decision may not be transferred to the board. Boards may also involve the nominating committee when identifying which seats to eliminate during a downsizing.

18. When must a nominating committee identify director nominees for mid-term board vacancies?

If a mid-term vacancy results in the board's composition having fewer than 60 percent stockholder-elected directors, filling the vacancy will likely require a special election. Just as in the annual director elections, the nominating committee identifies the director-nominees for special elections. This is because the institution may not fill a vacant seat through an appointed director when the number of stockholder-elected directors is fewer than 60 percent of the board. As noted in Q&A 16, this does not prevent an eligible stockholder from seeking a floor nomination independent of the nominating committee.

<u>Activities of Directors, Officers, Employees, and Agents in the Director Nomination Process</u>

19. What role may an institution's board of directors have in the nomination process?

Directors may discuss with the nominating committee their views on the role of the board and, if permitted in the institution's policies, discuss the functions of the board, needed skills and expertise, time requirements to serve on the board, minimum attendance at board meetings, and mandatory training required of directors. Directors may also attend local gatherings to promote the benefits and rewards of board service and encourage voting stockholders to make themselves available as potential director-candidates or to serve on the nominating committee. In addition, directors may suggest names of potential candidates for director positions to the nominating committee. However, the board should avoid activities that could be construed as influencing the nominating committee's vote on its slate of nominees, particularly those directors seeking re-election to the board. For example, no director may be present when the nominating committee deliberates or votes on its slate of nominees.

20. May an institution, its officers, employees, or agents assist the nominating committee in its duties?

FCA regulation § 611.325(e) requires each Farm Credit bank and association to provide its nominating committee certain core documents. In addition, System institution staff may provide administrative support to the committee, such as setting up meeting spaces, setting appointments for the committee to speak with candidates, and collecting standard candidate information. Policies and procedures adopted under §§ 611.320 and 611.325 may also allow institution staff to provide names of potential director candidates to the nominating committee, but this opportunity must be available to any employee and not be confined to senior officers. The cooperative nature of System institutions means the voting stockholders determine who is qualified to serve on the board. FCA regulations at § 611.320(b) and (d) require institution staff to remain impartial in director elections and prohibits them from directly or indirectly influencing the nomination and election of directors.[5] An institution's impartiality in election policies should instruct staff to avoid activities that could be construed as intended to influence the nominating committee's vote on its slate of director-nominees. These activities include substituting the judgment of the nominating committee for that of the officer, employee or agent. Also, no staff or agent of the institution may be present when the committee deliberates or votes on its slate of nominees.

Copy to: The Chief Executive Officer of each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation
Section 4.25 Service Corporations

[5] This does not affect the authority of any institution staff holding voting stock in the institution to cast a vote.

Type: Bookletter
Section Number: BL-049
Section Title: Adequacy of Farm Credit System Institutions' Allowance for Loan Losses and Risk Funds
Old/Additional ID: [Old/Additional ID]

April 26, 2004

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Roland E. Smith, Chief Examiner
Office of Examination

Subject: Adequacy of Farm Credit System Institutions’ Allowance for Loan Losses and Risk Funds

This bookletter informs Farm Credit System (System) institutions of the Farm Credit Administration's (FCA or agency) expectations regarding the process used to determine the adequacy of their allowance for loan losses (ALL) and risk funds. This bookletter provides guidance to System institutions on principles for maintenance of an adequate level of the ALL to ensure prudent risk funds management. With the issuance of this bookletter, the agency's objective is to establish minimum criteria that each System institution should consider in its process used to determine the adequacy of its ALL and risk funds. Thus, the criteria communicated in this bookletter will be used by FCA examiners to evaluate the process a System institution uses to determine the adequacy of its ALL and risk funds. This bookletter also identifies key elements of sound business principles and practices for risk funds management by System institutions.

Background Information

For many years, the Securities and Exchange Commission (SEC) and the other Federal banking agencies[1] have provided guidance concerning their expectations regarding the ALL and related documentation. Most recently, in July 2001, the SEC issued Staff Accounting Bulletin (SAB) No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues, and the other Federal banking agencies issued an Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (Interagency Policy Statement). Both the SEC's and the other Federal banking agencies' guidance focused significant attention on the level of documentation needed by lenders in order to support the amounts in their ALL accounts. SAB No. 102 and the Interagency Policy Statement reflect a continued refinement of accounting guidance that has served to shape industry and System practices in this area.

[1]We refer collectively to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision as the "other Federal banking agencies."

To date, the agency has issued only limited formal guidance to System institutions on their ALL process. Section 621.5 of our accounting and reporting regulations set forth the agency's only regulatory requirement addressing the ALL of System institutions. This regulation, which was originally adopted in 1986, provides only the broad guidance that "[e]ach institution shall maintain at all times an allowance for loan losses that is adequate to absorb all probable and estimable losses that may reasonably be expected to exist in the loan portfolio" and "[d]evelop, adopt, and consistently apply policies and procedures governing the establishment and maintenance of the allowance for loan losses . . . ." The only other substantive agency guidance is an examination directive issued in June 1986. This directive outlines factors that the agency believes System institutions should consider in the evaluation of their ALL. The guidance in the directive is also very broad in nature. The intent of both the regulation and directive essentially was to have System institutions follow generally accepted accounting principles (GAAP).

Until now, the agency has not issued any formal guidance to System institutions with regard to our expectations for their risk funds management practices. The ALL represents a significant component of almost every System institution's risk funds. Thus, our examiners routinely evaluate a System institution's level of risk funds (i.e., ALL and capital) to assess its overall risk-bearing capacity. While the other Federal banking agencies' Interagency Policy Statement does not address risk funds, the guidance on risk funds management in this bookletter tracks best business practices with regard to boards of directors and management responsibilities.

Criteria for the ALL and Risk Funds Process

When a System institution determines the adequacy of its ALL and risk funds, we expect the process it uses to consider the following criteria:

I. <u>FCS Board of Directors' Responsibilities</u>

Effective board oversight of an institution's ALL determination is one of the keystones of a sound risk funds management process. Such oversight is crucial to a board's understanding of the process by which the institution estimates the losses inherent in the loan portfolio and determines that the level of its ALL is adequate. To properly fulfill its responsibilities, a board should at a minimum:

- Take measures to ensure its understanding of how the adequacy of the ALL relates to the overall business strategies of the institution, including those that relate to risk funds management;

- Direct management to develop and maintain appropriate policies, procedures, and internal controls that specifically address the institution's unique goals, systems, risk profile, personnel, and other resources necessary to identify the institution's exposure to loan losses and to ensure that an adequate level of the ALL and overall risk funds are continuously maintained to safeguard the institution against financial risks;

- Oversee and monitor the ALL process by ensuring internal controls are in place to consistently determine the institution's ALL in accordance with its policies and procedures and GAAP, including policies for recognition of impaired and nonaccrual loans and for recording loan charge-offs and recoveries;

- Direct management to develop documentation standards that require appropriate written supporting documentation for its ALL adequacy determination, build discipline and consistency into the ALL determination process, and ensure that all relevant factors are appropriately considered in the ALL analysis;

- Preclude management from implementing ALL methodologies that would allow the institution's earnings to be inappropriately manipulated;

- Review management's analysis and basis for its determination of the adequacy of the institution's level of the ALL in conjunction with its overall risk funds determination, including the basis for the institution's ALL methodologies and any revisions to the methodologies and/or overall process;

- Provide appropriate oversight, either directly or through a board-established audit committee, of the ALL process, including coordination and communication with the institution's independent qualified public accountant having audit responsibilities with respect to the institution's ALL process;

- Review and approve the overall level of the institution's ALL, including additions and reductions in its level and approval of any reductions of overall risk funds; and

- Ensure the institution is in compliance with FCA's regulatory requirements, the institution's policies, procedures, and internal controls, GAAP, and other applicable guidance that pertains to the maintenance of an adequate level of the ALL and prudent risk funds management.

II. <u>Management's Responsibilities</u>

Management is responsible for ensuring that the institution's risk funds are properly managed. Management should at a minimum:

- Develop and maintain procedures that translate the board's major business strategies and policies addressing the adequacy of the institution's risk funds into appropriate performance standards and expectations for risk funds management;

- Ensure the methodologies for determining the adequacy of capital, the ALL, and overall risk funds remain appropriate for the institution;

- Perform periodic reviews of the institution's lending and loan review functions;

- Maintain a record of its analysis and the basis for its determination of the adequacy of the institution's overall risk funds, including an assessment of capital and the ALL levels;

- Implement and maintain a management information system that appropriately tracks information necessary to assess the adequacy of the institution's risk funds; and

- Establish proper internal controls and audits of the risk funds management process.

Management should assess the adequacy of the institution's ALL on a regular basis but not less than quarterly. If management determines that the level of the institution's ALL is inadequate or excessive, a provision or reversal should be made to the ALL to assure the accuracy of financial statements. Likewise, management should ensure that loan losses are charged off to the ALL at the time a determination is made that a loan or portions thereof are known to be uncollectible and that recoveries are appropriately recognized when realized.

III. <u>Methodologies</u>

System institutions are expected to develop and document systematic methodologies to determine their ALL and related provisions for loan losses. Crucial to sound ALL methodologies is that they incorporate management's current judgments about the credit quality of the institution's loan portfolio through a disciplined and consistently applied process. It is important that the methodologies achieve a high level of correlation between changes in the level of the ALL and significant favorable or unfavorable trends in the quality of the loan portfolio. An institution's methodologies should be influenced by and tailored to entity-specific factors, such as the institution's size, organizational structure, business strategy, economic environment, management style, staff experience, loan portfolio characteristics, loan administration procedures, information systems, and internal controls.

While different institutions may use different methods, there are certain common elements that should be included in any methodologies to be considered effective. Each institution's methodologies generally should:

- Include a detailed analysis of estimated losses in the loan portfolio performed on a regular basis but not less than quarterly;

- Consider all loans (whether on a individual or group basis);

- Identify loans to be evaluated on an individual basis under Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, and segment the remainder of the loans (those that will not be individually evaluated) into groups of loans with similar characteristics for evaluation under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*;

- Consider all relevant qualitative and quantitative factors that may affect loan collectibility including the risks associated with lending in a single sector;

- Be applied consistently but, when appropriate, modified for new factors;

- Consider the overall quality of the institution's credit review programs, the concentrations of lending in a single sector, and the overall quality and experience of management;

- Place emphasis on sound management judgment;

- Consider relevant observable data;

- Review historical loan loss experiences, taking into account current conditions;

- Consider the particular risks inherent in different kinds of lending, including changing government policy regarding agricultural subsidies and the volatility of the agricultural operating environment;

- Consider collateral values, repayment patterns, and off-farm sources of income;

- Require that the methodologies function be performed by competent and well-trained staff;

- Include an analysis of deterioration in concentrations of credit, classes of borrowers, and pledged collateral based on volume and type of loans;

- Give consideration to current economic conditions and trends in delinquencies and nonaccruals;

- Include an analysis of recent trends in portfolio volume, maturity, and composition;

- Be based on reliable data;

- Include clear explanations of the supporting analyses and rationale; and

- Include a systematic and logical method to consolidate losses.

IV. Documentation Standards

Documentation is critical to an institution's ALL process in that it provides evidence that its ALL is consistently maintained at an adequate level. Appropriate written supporting documentation for an institution's ALL facilitates the loan loss review process, builds consistency into the determination process, and ensures that all relevant factors are considered in the analysis process. An important part of the ALL process is that there is documentation supporting the relationship between the findings of the detailed review of the institution's loan portfolio and the level of the ALL and related provisions reported by the institution. An institution should establish documentation standards that address the following elements:

- Policies and procedures for the process, including an internal control system to ensure the integrity of the process;

- ALL methodologies and related validation process;

- Accounting policies for loans and loan losses, including policies for charge-offs and recoveries and the fair value of collateral, where applicable;

- Roles and responsibilities of staff and departmental units, including the lending function, credit review, financial reporting, internal audit, board and management, audit committee, and others, as applicable, who determine or review the level of the ALL reported in the institution's financial statements;

- Adjustments to the ALL process and methodologies;

- Loan-grading system and process; and

- Summary or consolidation of the ALL amounts.

V. Internal Controls

For safe and sound operations, each institution should maintain an internal control system over its ALL process. Sound internal controls will ensure that the institution's ALL process is reasonable, the level of the ALL is maintained in accordance with GAAP, and prudent risk funds management practices are in place. A sound internal control system should:

- Include measures to provide assurance regarding the reliability and integrity of information used in the ALL process;

- Assure compliance with relevant laws and regulations, internal policies and procedures, GAAP, and other applicable guidance;

- Include a review of the documentation that supports the ALL methodologies and process for completeness and sufficiency;

- Include a well-defined loan review process that contains an effective loan-grading system, ensures that all relevant loan review information is appropriately considered in estimating losses, and provides clear formal communications and coordination among all parties within the institution who are involved in the ALL process;

- Provide for an audit of the ALL process and the adequacy of the level maintained by a qualified public accountant who is independent of the institution; and

- Reasonably assure that the level of the ALL is adequate to cover the losses inherent in the institution's loan portfolio and is maintained in accordance with GAAP.

VI. <u>FCA's Examination</u>

FCA examiners will assess the adequacy of an institution's ALL and overall risk funds based on evaluation of the overall processes in use by the institution. The assessment will focus on the institution's policies, practices, internal controls, documentation, methodologies, and other tools used to determine the adequacy of its ALL and overall risk funds. The performance results of an institution's risk funds management process will be considered when evaluating risk exposure levels in accordance with the FCA's Financial Institution Rating System.

This bookletter endorses the guidance issued by the SEC and by the other Federal banking agencies. The agency believes the guidance in this bookletter for the ALL, like the SEC's SAB No. 102 and the other Federal banking agencies' Interagency Policy Statement, is consistent with GAAP. In addition, the agency is issuing an examination bulletin (attached to our Informational Memorandum dated April XX, 2004) that establishes further direction for the agency's examination focus on System institutions' methodologies and documentation needed to support the ALL.

If you have any questions about this bookletter, please contact me at (703) 883-4160, or correspond with me on the Internet at e-mail address *smithr@fca.gov,* or Tom Holland, Special Examination and Supervision Division, Office of Examination, at (703) 883-4484, or correspond with him on the Internet at e-mail address *hollandt@fca.gov.*

Type:	Bookletter
Section Number:	BL-051
Section Title:	Maximum Director Compensation for 2006
Old/Additional ID:	[Old/Additional ID]

December 15, 2005

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit Banks

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Maximum Director Compensation for 2006

The members of the Farm Credit Administration (FCA) Board recognize the increased responsibilities, expertise, and time spent on board activities by Farm Credit System (FCS or System) bank directors. For safety and soundness reasons, we believe it is important that these directors be adequately compensated for their efforts. Adequate and appropriate compensation should reflect the significant nature of bank directors' fiduciary duties and responsibilities. Adequate compensation is also critical to attract qualified individuals to consider serving as bank directors. As discussed below, compensation for FCS bank directors is limited by statute and FCA regulations. However, the statute and regulations provide the FCA Board the authority to waive the limit for exceptional circumstances or to adjust compensation limits for safety and soundness reasons.

The Farm Credit Act of 1971, as amended, states that "the Farm Credit Administration shall monitor the compensation of members of the board of directors of a System bank received as compensation for serving as a director of the bank to ensure that the amount of the compensation does not exceed a level of $20,000 per year, as adjusted to reflect changes in the Consumer Price Index for all urban consumers published by the Bureau of Labor Statistics, unless the Farm Credit Administration determines that such level adversely affects the safety and soundness of the bank." The FCA Board finds that System bank director duties and responsibilities are an integral component to ensuring the safety and soundness of Farm Credit banks. Importantly, these duties and responsibilities have increased substantially over time. The increase in duties and responsibilities are associated with regulatory- and market-driven governance and reporting and disclosure requirements in an increasingly complex and sophisticated financial services sector, as well as an agricultural sector that is increasingly driven by technological change. Fulfillment of these increased duties and responsibilities is vital to the continued safety and soundness of System banks and related institutions.

Based on the comments we received in connection with our solicitation on Farm Credit bank director compensation, and data received and analyzed by the Agency, we have determined that this correlation between Farm Credit bank director duties and responsibilities and safety and soundness requires a one-time adjustment to the current limitation on director compensation. It is a matter of record that Farm Credit bank director compensation was capped at a level approximately 18 percent below that of commercial bank directors in 1992. Since that time, inflationary adjustments have increased the cap on System bank director compensation from $20,000 to $27,060, or approximately 35 percent. Comparable commercial bank director compensation has also risen due to inflation, but it has risen more dramatically due to legislative changes and investor expectations that increased director duties and responsibilities, out of concerns for bank safety and soundness. We estimate this latter effect has caused a 93 percent increase over the same time period.

During this time period, Farm Credit bank director compensation has not risen at all despite comparable increases in director duties and responsibilities arising out of concern for System bank safety and soundness. In addition, System bank consolidations and growth have contributed to the increasing complexity of bank operations and transactions. As a regulator, we expect a level of professionalism, commitment, and expertise on the part of System bank directors that compares favorably to commercial bank directors, notwithstanding the fact that commercial banks provide a broader range of financial services, many of which entail additional operational risk. After reviewing relevant director compensation information, we are authorizing System banks to pay fair and reasonable director compensation for 2006 at a level not to exceed $45,740 (as may be adjusted for inflation). We note that this adjustment also results in an amount that is about 18 percent below current commercial bank director compensation levels. This differential is consistent with what existed when Congress placed a cap on Farm Credit bank director compensation in 1992. As required by the Act, FCA will continue to provide annual adjustments to this bank director compensation level based on changes to the CPI.

While we believe this change is consistent with the limitation imposed by Congress in 1992, System boards will still need to assess their own unique circumstances and the demands placed upon their board members in setting director compensation levels within this authorized limitation. Under FCA regulation § 611.400, bank boards will need to modify their written policy on director compensation to explain and support a higher level of compensation for their directors.

We are not changing § 611.400 of our regulations dealing with preapproved waivers to this new limitation. We note, however, that System banks must be judicious when exercising this 30 percent waiver authority. Specifically, System banks must fully identify in their annual report, both the specific extraordinary event, or events, and the additional time and effort spent on those events that justify the higher compensation level through waiver. This justification must be provided individually for each director who is compensated under the regulatory waiver provision.

Type: Bookletter
Section Number: BL-052
Section Title: Tobacco Buyout Lending and Investment Opportunities
Old/Additional ID: [Old/Additional ID]

January 25, 2006

To: Chairman, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Tobacco Buyout Lending and Investment Opportunities

On October 22, 2004, Congress enacted the "Fair and Equitable Tobacco Reform Act of 2004" (Tobacco Act) as part of the "American Jobs Creation Act of 2004."[1] The Tobacco Act repeals the Federal tobacco price support and quota programs, provides payments to tobacco "quota owners" and producers for the elimination of the quota, and provides an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. Tobacco quota holders and producers will receive 10 years of equal payments under a contract with the Secretary of Agriculture. The Tobacco Act also includes a provision that allows the quota holders and producers to assign to a "financial institution" the right to receive the contract payments "so that they may obtain a lump sum or other payment." On April 4, 2005, the United States Department of Agriculture (USDA) issued a Final Rule implementing the "Tobacco Transition Payment Program" (Tobacco Buyout).[2]

The Farm Credit Administration (FCA or Agency) has determined that Farm Credit System (FCS or System) institutions are "financial institutions" within the meaning of the Tobacco Act and are therefore eligible to participate in the Tobacco Buyout. FCA further recognizes that the Tobacco Buyout has significant implications for some FCS institutions and the tobacco quota holders and producers they serve. FCA believes it is essential that FCS institutions be able to provide their borrowers the option to immediately receive Tobacco Buyout contract payments and reinvest them in future business opportunities. This Bookletter explains the Agency's position on the options available to System institutions for utilizing the Tobacco Buyout to meet their borrowers' financial needs under both their lending and investment authorities.

Assignments and Successor-in-Interest Contracts

Under the USDA Final Rule, payments will be made to tobacco quota holders and producers by the Commodity Credit Corporation (CCC). The USDA Final Rule provides that tobacco quota holders and producers may assign their right to receive Tobacco Buyout contract payments to a third party (including a System institution) in two ways: (1) through an "assignment" of payments or (2) by entering into a "successor-in-interest" contract with a third party.

The following table highlights some of the differences between an assignment of payments and a successor-in-interest contract.

Assignments	Successor-in-Interest Contracts
• May be entered into at any time beginning with first payment in 2005. • May include all or part of the payments. • The tobacco quota holder or producer retains ownership of the contract and the related rights and obligations under the contract. • Are subject to administrative offset under the Debt Collection Act of 1996. • Can be revoked at any time with consent of the assignee.	• May be entered into starting with the FY 2006 payment. • Partial successor-in-interest contracts are not allowed. • The successor purchases the entire contract and all related rights and obligations associated with the contract. • If a claim is owed by the seller to the United States, the CCC will not approve the successor-in-interest contract. Therefore, the successor-in-interest contract is not subject to administrative offset. • May not be revoked. • The CCC will allow the sale of successor-in-interest contracts to another party.

How the System Can Utilize the Tobacco Buyout to Meet Borrower Needs

Option 1 - Loans

Under the System's lending authority, System institutions can make loans to eligible borrowers and accept Tobacco Buyout contract payments as a dedicated source of repayment and/or primary or secondary collateral for the loans. As with any loan, loans related to Tobacco Buyout contract payments should be made in accordance with prudent credit underwriting practices, and all credit factors should be considered. System institutions may adopt special underwriting standards for this program that take into account their borrowers' financing needs and the unique nature of lending transactions related to the Tobacco Buyout.

Option 2 – Investments

This option includes direct assignments or successor-in-interest contracts, as well as securities created from Tobacco Buyout contract payments. The FCA considers investments related to the Tobacco Buyout an important mission-related activity because such investments can provide tobacco quota holders and producers immediate access to funds to help ease their transition away from government price support for future production and to meet their current financial needs.

The FCA has determined that investments in Tobacco Buyout instruments are comparable to and share many characteristics with other obligations of the United States, its agencies, instrumentalities, and corporations authorized under FCA regulation § 615.5140(a)(1). However, we also recognize the unique nature of the Tobacco Buyout and that it will have a significant financial impact on many tobacco quota holders and producers. Therefore, we concluded that investments in Tobacco Buyout instruments should be classified separately and treated as mission-related investment activities under § 615.5140(e) that are not subject to the 35 percent portfolio cap for System bank investments under § 615.5132.

The FCA Board has approved "Tobacco Buyout instruments" as eligible investments that FCS banks, associations, and service corporations may purchase and hold under § 615.5140(e) with the following conditions:

1. "Tobacco Buyout instruments" means contracts and securities related to the Tobacco Buyout, which was established under the Tobacco Act, including:

    a. Assignments of Tobacco Buyout contract payments by tobacco quota holders and producers,
    b. Successor-in-interest contracts, and
    c. Securities backed by Tobacco Buyout contract payments, assignments, or successor-in-interest contracts.

2. Prior to purchase, each FCS institution board must adopt written policies governing their investments in Tobacco Buyout instruments in accordance with § 615.5133. Policies covering Tobacco Buyout instruments may be included in the institution's policies covering other investments. Risk limitations and investment management should be appropriate for the nature of the institution's investment activities. Internal valuation models may be utilized to determine the value of Tobacco Buyout instruments at purchase and sale. FCS institutions may also use their own internal models to determine the fair value of Tobacco Buyout instruments on a monthly basis.

3. FCS associations must obtain the approval of their funding bank prior to investing in Tobacco Buyout instruments.

4. Investments in Tobacco Buyout instruments must be maintained in a portfolio separate from other eligible investments so that they are readily identifiable.

Risk Management

Engaging in lending and investing activities related to the Tobacco Buyout may carry unique operational risks, particularly with assignment transactions. System institutions should fully understand the Tobacco Buyout regulations, contract payment procedures and requirements, and tax implications.

System institutions should ensure they have appropriate policies, procedures, and internal controls in place to effectively manage all risks associated with Tobacco Buyout lending and investing activities. System institutions should also consider developing policies to ensure that all tobacco quota holders and producers are treated fairly and equitably. All System institutions interested in investing in Tobacco Buyout instruments should establish policies that place risk limits on these investments based on their institution's risk-bearing capacity. In addition, System associations that want to purchase Tobacco Buyout instruments can only do so in amounts approved by their funding bank. FCA will evaluate the safety and soundness of Tobacco Buyout related lending and investment activities through its ongoing examination process.

Capital Treatment

Tobacco Buyout contract payments are made by the CCC and have the same contractual sanctity as other CCC payments. Although the funding for Tobacco Buyout payments is primarily derived from assessments levied upon manufacturers and importers of tobacco products, CCC's obligation is the same as for any other CCC contract.

Our May 13 Bookletter required successor-in-interest contracts to be risk-weighted at 20 percent. After our Bookletter was issued, the CCC clarified that there are no payment contingencies for Tobacco Buyout contracts. In response, the banking regulators in November changed their risk-weighting for these successor-in-interest contracts to zero percent. Because of the changes made by the CCC and the actions of the banking regulators, *the Agency has concluded that all successor-in-interest contracts, both new and existing, should be risk-weighted at zero percent.*

Assignments of Tobacco Buyout payments are not obligations of the CCC, but rather of the borrower. Typically, assignments of all kinds are taken as collateral for loans. Tobacco Buyout payments received from an assignment are subject to borrower contingencies in ways that successor-in-interest contracts are not. For instance, the borrower's failure to pay federal income taxes may cause the association to lose all or some of the expected payments from the assignment. Our May 13 Bookletter allowed loans supported by Tobacco Buyout assignments to be risk-weighted at 20 percent. The banking regulators require loans supported by Tobacco Buyout assignments to be risk-weighted at 100 percent. *The Agency has concluded that all loans recorded on and after January 1, 2006 that are supported by Tobacco Buyout assignments should be risk-weighted at 100 percent.* However, associations have made loans secured by Tobacco Buyout assignments following our earlier guidance on risk-weighting. *The Agency has concluded that System institutions should continue to risk-weight at 20 percent all loans recorded before January 1, 2006 that are supported by Tobacco Buyout assignments.*

REVISED CAPITAL RISK-WEIGHTS

Asset Type	Recorded before Jan. 1, 2006	Recorded Jan. 1, 2006 or later
Successor-in-interest contracts	0%	0%
Loans secured by assignments	20%	100%

Additional Information

USDA has Tobacco Buyout information on their Web site at www.fsa.usda.gov/tobacco, including the tobacco transition assessment and payment regulations. USDA also plans to release supplementary Federal Register Notices and press releases to provide the public additional program details as they become available. Furthermore, it is expected that the IRS will post information on Tobacco Buyout tax implications on their Web site, including their ruling on the tax treatment for assignments and successor-in-interest contracts.

If you have questions on your permissible lending and investment activities related to the Tobacco Buyout, please contact Laurie Rea, Associate Director, Office of Regulatory Policy, at (703) 883-4232 or by email at real@FCA.gov.

[1]P.L. No. 108-357 (Oct. 22, 2004).

[2]70 Fed. Reg. 17150 (April 4, 2005).

Type: Bookletter
Section Number: BL-053
Section Title: Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets
Old/Additional ID: [Old/Additional ID]

February 12, 2007

To: The Chief Executive Officer
The Chief Financial Officer
Each Farm Credit Bank and Association

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets

A Farm Credit System (FCS or System) bank asked the Farm Credit Administration (FCA or Agency) to apply a lower regulatory capital risk weight to certain loans and leases to generation and transmission and electric distribution cooperatives (electric cooperatives). This request was made pursuant to FCA's reservation of authority as defined under § 615.5210(f). Under the reservation of authority provision, if the risk weight specified in § 615.5211 does not appropriately reflect the level of risk in an asset, the FCA may, on a case-by-case basis, determine the appropriate risk weight for the asset.

Upon review and analysis of the electric cooperative industry, the FCA acknowledges the unique characteristics and lower risk profile of this industry segment. This lower risk profile is supported, in part, by the financial strength and stability of the underlying member systems, the ability to establish user rates with limited third-party oversight, and the exclusive service territories encompassing rural America -- all of which insulate the electric cooperative industry from many of the credit-related risks experienced by investor-owned utilities. The strength and lower risk profile of the electric cooperative industry are further supported by its minimal loss history and sound credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs).

Based on this industry's risk profile and our analysis, the FCA has determined that exposures to certain loans, leases, participation interests, and debt securities (Assets) of the electric cooperative industry warrant a lower regulatory capital risk weight, subject to specified conditions described herein. The revised regulatory capital treatment is specific to the electric cooperative industry. **All FCS institutions may apply the revised regulatory capital risk weight to their electric cooperative Assets as indicated in this guidance retroactive to January 1, 2007.**

Assets Subject to Lower Regulatory Capital Risk Weight

The Agency assigns exposures to electric cooperative Assets, subject to specified conditions prescribed below, to the 50-percent risk-weight category set forth in § 615.5211(c).

The Agency further assigns exposures to such electric cooperative Assets to the 20-percent risk-weight category set forth in § 615.5211(b), subject to the specified conditions prescribed below, if the Asset is rated in one of the two highest credit rating categories (e.g., AAA or AA) by an NRSRO. The risk weighting is based on the NRSRO credit rating of the specific Asset (issuance) and not the issuer rating. If an Asset has more than one NRSRO rating, the lowest rating determines whether this risk weighting applies.

Notwithstanding the guidance in this Bookletter, all asset- and mortgage-backed securities (even if they satisfy the conditions below) will remain subject to the current regulatory risk-based capital treatment under § 615.5211.

Conditions for Application of Lower Regulatory Capital Risk Weight

(1) The Asset must be risk rated 1 through 7 under the System's risk-rating model. The System has adopted standard risk ratings based on a combined risk-rating model that utilizes a two-dimensional risk rating process that includes a risk rating (1-14 in which 1-9 are "Acceptable") and a collateral-rating (Loss Given Default) measurement for each loan.

(2) Annually, the cooperative must not generate more than 20 percent of its revenues from non-core business, regardless of the risk rating or NRSRO credit rating of the Asset. This revenue test must be performed on a consolidated basis, and Assets of cooperatives that exceed this test must be risk weighted subject to the current capital regulations even if the cooperatives have no financial obligation for their controlled non-core subsidiaries.

- For generation and transmission cooperatives, non-core business is defined as any activity other than the generation and transmission of electricity and includes, but is not limited to, coal gasification and coal mining in excess of production needs for owned generation.

- For electric distribution cooperatives, non-core business is defined as any activity other than the generation, purchase, and distribution of electricity and includes, but is not limited to, such interests as gas distribution, propane sales, real estate development, and communications.

(3) For cooperatives constructing a new baseload power plant, regardless of the risk rating or NRSRO credit rating of the Asset:

- The plant must not be nuclear-powered (regardless of construction costs); and

- Construction costs must not exceed 25 percent of the cooperative's total assets. If construction costs exceed 25 percent of the cooperative's total assets, then exposures to all the electric cooperative's Assets held by a System institution must be risk weighted in accordance with the current regulations. (Note: Once the new baseload plant is placed in service, however, the cooperative will be eligible for this lower risk-weighting as long as the Asset meets all other conditions.)

Any electric cooperative Asset that does not meet the above conditions will remain subject to the current regulatory capital risk weight.

Other Matters

In the event that our periodic reviews or examinations indicate that a particular electric cooperative Asset imposes risks that are not commensurate with the risk weight specified in this guidance, or if risk(s) within the electric cooperative industry significantly changes, the FCA may require System institutions to change the assigned risk-weight category for the Asset or class of Assets. In addition, System institutions are required to maintain documentation evidencing compliance with the conditions above to receive the more favorable capital treatment.

We emphasize FCA continues to maintain its reservation of authority to determine the appropriate risk weight for any Asset that imposes risks not commensurate with the risk weight assigned. The regulatory capital treatment prescribed in this guidance is specific to electric cooperative Assets. This lower risk-weight category does not apply to any other industries or assets.

If you have questions on the guidance provided in this bookletter, please contact Laurie Rea, Associate Director, Office of Regulatory Policy, at (703) 883-4232 (or by email at real@FCA.gov) or Michael Anderson, Policy Analyst, Office of Regulatory Policy at (303) 696-9737, ext. 2081 (or by email at andersonm@FCA.gov).

Type: Bookletter
Section Number: BL-054
Section Title: Effect of FAS 158 on Regulatory Capital
Old/Additional ID: [Old/Additional ID]

January 8, 2008

To: The Chief Executive Officer
The Chief Financial Officer
Each Farm Credit Bank

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Effect of FAS 158 on Regulatory Capital

In September 2006, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158). FAS 158 requires sponsors of a single-employer defined benefit postretirement plan, such as a pension plan or health care plan, to recognize the funded status of each such plan on its balance sheet. An overfunded plan is recognized as an asset, while an underfunded plan is recognized as a liability. These over- and under-funded amounts must be recorded as adjustments to currently reported balance sheet amounts through initial and ongoing entries to the accumulated other comprehensive income (AOCI) accounts in equity capital. Farm Credit System (System) banks affected by the requirements of FAS 158 must recognize its initial effects, if any, for financial reports issued as of December 31, 2007.

The funding status of these postretirement plans will change with the market valuation of plan assets; consequently, equity capital will fluctuate. The funding status of these plans and the effect on the plan sponsor's balance sheet will provide useful information to plan participants, purchasers of System debt, and others, including the Farm Credit Adminstration (FCA). For regulatory capital purposes, though, the application of FAS 158 could make it more difficult to monitor other changes in the bank's risk-adjusted assets and regulatory capital. Consequently, the FCA has determined that the denominator of the net collateral ratio should exclude the effects of the adoption and application of FAS 158.[1]

The application of FAS 158 will have no effect on System institutions' permanent capital, total surplus, and core surplus calculations because FCA Regulation § 615.5207(j) already requires the exclusion from permanent capital--and, by extension, from total surplus and core surplus as well--of "the net effect of all transactions covered by the definition of 'accumulated other comprehensive income' contained in the Statement of Financial Accounting Standards No. 130, as promulgated by [FASB]." Consequently, FAS 158 would affect only "total liabilities," the denominator of the net collateral ratio.

We direct each affected Bank to exclude the effects of the application of FAS 158 from the net collateral calculation, as follows:

- file Call Report Schedule RC-J that includes the net effect of any adjustments to liabilities required by this bookletter on line 21, and

- file an addendum to Call Report Schedule RC-J that shows the accounting transactions required by FAS 158 and reconciles related AOCI adjustments with reported regulatory capital ratios.

For further information on accounting for defined benefit postretirement plans, institutions should refer to FAS 158; SFAS 87, Employers' Accounting for Pensions; and FAS 106, Employers' Accounting for Postretirement Benefits Other Than Pensions.

If you have questions on the guidance provided in this bookletter, please contact Thomas Dalton, CPA, Associate Director, Office of Regulatory Policy, at (703) 883-4460 (or by email at daltont@FCA.gov) or William Dunn, Senior Financial Analyst, CFA, CPA, Office of Regulatory Policy at (703) 883-4489 (or by email at dunnw@fca.gov).

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[1]The Federal banking agencies require their regulated entities to exclude from regulatory capital any amounts recorded in AOCI resulting from the adoption and application of FAS 158. See: Office of the Comptroller of the Currency, Joint News Release NR 2006-136, "Agencies Announce Interim Decision on Impact of FAS 158 on Regulatory Capital," December 14, 2006.

Type:	Bookletter
Section Number:	BL-055
Section Title:	Floor Nomination Procedures for System Associations and Banks
Old/Additional ID:	[Old/Additional ID]

February 14, 2008

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Floor Nomination Procedures for System Associations and Banks

In the election of directors, the role of the nominating committee is to present, for stockholder vote, a slate of eligible candidates for service on the institution's board of directors.[1] A floor nomination is the only other manner of nominating candidates to serve as stockholder-elected directors. This bookletter provides guidance on the procedures Farm Credit System (System) associations are expected to use in accepting nominations from the floor. Farm Credit banks that allow floor nominations should also follow the guidance provided by this bookletter.

Background

Section 4.15 of the Farm Credit Act of 1971, as amended (Act), addresses nominations for director elections. Section 4.15 requires System associations to have nominating committees and to accept floor nominations, while instructing the Farm Credit Administration (FCA) to issue regulations on Farm Credit bank director elections so a choice of nominees is assured. FCA regulation § 611.325 requires Farm Credit banks and associations to have nominating committees. Also, FCA regulation § 620.21(d)(4) requires Farm Credit banks and associations to disclose in their annual meeting information statements whether floor nominations are allowed and states that associations must accept floor nominations. We encourage Farm Credit banks to accept floor nominations as well.

Floor Nomination Procedures

The manner of conducting floor nominations is generally guided by an institution's bylaws and general corporate law principles. However, an association's general authority to administer the election of stockholder directors is subject to the specific requirements of section 4.15 of the Act. Section 4.15 requires that "[nominations] shall . . . be accepted from the floor," which is an express right granted to the stockholder that may not be unduly restricted in a way that effectively weakens it. Thus, procedures for nominations from the floor may not be unduly burdensome nor have the effect of denying voting stockholders the right to name candidates through floor nominations.

For example, a System association whose bylaws, policies or procedures require that floor nominations have signatures in support of the nomination before adding the nominee to the ballot, has converted the floor nomination into a nomination by petition, effectively denying voting stockholders the right to name candidates from the floor. Section 4.15 does not require stockholder support before a floor nomination is placed on the election ballot. Also, the recognized authority on parliamentary procedures, Robert's Rules of Order, explains that nominations from the floor are made at meetings where elections are pending and do not need a “second" before being placed on a ballot, although members may second a nomination to show support.[2]

System associations may establish other procedural requirements for director elections, such as determining that a floor nominee is willing to accept the floor nomination. Also, FCA regulations require that all nominees, including those named from the floor, be eligible for the director position for which the person is nominated and make the disclosures required by FCA regulation § 620.21(d)(1) and (d)(5).

Please contact Andrew D. Jacob, CFA, Director, or Gary Van Meter, Deputy Director, Office of Regulatory Policy, at (703) 883-4414, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov if you have any questions regarding this communication.

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[1]FCA provided guidance on the nominating committee process in BL-043 Revised (March 8, 2007).

[2]Rule 46, Robert’s Rules of Order Newly Revised, 10th edition, at 417—424 (Perseus Books (2000)).

Copy to: The Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

Type: Bookletter
Section Number: BL-056
Section Title: Distribution of Director Candidate Information
Old/Additional ID: [Old/Additional ID]

September 11, 2008

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Distribution of Director Candidate Information

This bookletter clarifies the meaning of "campaign material" for purposes of Farm Credit Administration (FCA) regulation § 611.320(e) by differentiating campaign material from educational material. The bookletter explains that Farm Credit System (System) institutions may provide, to stockholders, supplemental material on director candidates without violating the prohibition on distributing campaign material when that material is educational in nature and all candidates have a fair and equal opportunity to provide educational material. With this guidance, the FCA is seeking to promote greater stockholder awareness and participation in the election of directors to the boards of banks and associations that are a part of the borrower-owned cooperative System.

Background

FCA regulation § 611.320(e) prohibits System institutions from distributing director candidate campaign material but allows institutions to provide voting stockholders with candidate biographies. In addition, System institutions are required to provide stockholders the disclosure information made by each candidate under FCA regulation § 620.21(d)(1) and (d)(5).[1] These rules are designed to ensure that System institutions remain impartial in administering director elections, while still providing voting stockholders with enough information to make informed choices when voting for director candidates. FCA regulation § 611.320 in particular was designed to keep System institutions free from even the appearance of endorsing or promoting a particular director candidate.

The FCA provided guidance on what might be considered campaign material in two Frequently Asked Questions (FAQs) issued for our governance rules.[2] Governance FAQ number 33 explained that a System institution may request additional candidate disclosure and biographical information on director candidates as long as it is requested from all candidates, serves a legitimate purpose, and is not campaign material. Governance FAQ number 34 explained that candidate personal statements or requests for votes would generally be considered campaign material, but information commonly found in résumés would likely be treated as biographical information.

In this bookletter we are providing additional clarification and guidance for identifying what is and what is not "campaign material" under the meaning of § 611.320(e). We are providing this clarification to ensure the interpretation of "campaign material" does not limit the distribution of appropriate information on director candidates to stockholders. The larger geographic territories of some System institutions make it unrealistic to expect stockholders to have meaningful knowledge of most director candidates without some supplemental information beyond the required disclosures. The large number of stockholders in many associations also makes it impractical or cost-prohibitive for candidates to mail or distribute information themselves.

We believe that an informed electorate facilitates good governance, but that objective must be balanced with maintaining System institutions' impartiality in director elections. All candidates must be treated by System institutions fairly and equally during the election process. Likewise, information provided to voting stockholders by the System institutions should facilitate making informed decisions. Therefore, System institutions may not distribute information to stockholders that would be considered campaign material.

Differentiating Educational Material from Campaign Material

Campaign material is information clearly intended to influence the voting decisions of stockholders, while educational material is designed to inform voting stockholders of the background, experience, and qualifications of each candidate.

Educational material is information provided by a candidate, in addition to the required disclosures under § 620.21(d)(1) and (d)(5), which does not directly promote the candidate or oppose another candidate. Educational material may describe a candidate, what he or she has done, and may include a candidate's education, background, positions held in other organizations, career accomplishments, civic and personal interests, and direct contact information. Educational material may also include the candidate's responses to questions developed by an institution when those questions are asked of all director candidates. A personal statement by the candidate that discusses his or her desire to serve as a board member or thoughts regarding the institution, would also be considered educational material, as long as the statement does not venture into the realm of campaigning.

Certain items clearly constitute campaigning, which institutions are prohibited from distributing, such as material expressly advocating the election or defeat of a candidate by using words like "vote for" or "vote against" or promising a specific benefit to voters if the candidate is elected. For example, material provided by a candidate promising to double patronage payments if he or she should win the elected office would be campaign material, while material indicating a candidate's support of a strong patronage program would be educational because it does not equate the election of the candidate to a specific result (i.e., more patronage).

Preserving Impartiality in Elections

Each System institution providing educational information to stockholders must take steps to preserve its impartiality and ensure the fair and equal treatment of all director candidates, including nominees from the floor. Those steps might include 1) developing a template for use by director candidates in submitting educational information to the institution to ensure the same set of questions is asked of all candidates; 2) establishing a word count or page limit for candidate submissions and/or responses to standardized questions; 3) providing candidate information in a neutral or unbiased sequence, such as alphabetically; and 4) naming all candidates. If a candidate fails to respond to the institution's request for educational information, the institution should either indicate that no response was received or restate the candidate's required disclosure. System institutions should also establish appropriate controls over making simple grammatical and syntactical corrections to candidates' educational material unless the institution's policy is to accept the educational material "as is." Whatever steps a System institution takes, the result must avoid the appearance that the institution is favoring or endorsing any particular candidate. All candidates, including nominees from the floor, are to be given the same opportunity to provide educational information and are to be treated fairly and equally in the process of collecting and providing the information to stockholders.

We encourage System institutions to disclose that director candidate educational material was prepared and submitted by the candidate and that the information is for educational purposes only. Institutions may also want to state that, by regulation, the institution must remain impartial and can neither endorse nor oppose any candidate. After floor nominations have closed, institutions may post candidate educational material on their Web sites simultaneously with, or immediately after, distributing the material in paper form to the voting stockholders.

As before, director candidates may continue to mail or otherwise distribute their own campaign material at their own expense.

Updating Policies and Procedures on Impartiality in Elections

Each System institution is required by FCA regulation § 611.320(a) to have policies and procedures addressing the institution's impartiality in director elections. We expect each System institution that decides to provide educational material on director candidates to revise its policies and procedures to reflect the guidance provided in this bookletter. Institutions, when modifying existing policies and procedures, must ensure that all candidates are treated fairly and without bias or favoritism, particularly in the manner in which educational material is collected and disseminated.

Information to address in revisions to policies and procedures would include 1) defining what candidate material the institution considers as educational; 2) describing the manner in which that information will be collected from candidates, processed by the institution, and distributed to voting stockholders; and 3) identifying the controls used to ensure the institution's impartiality is maintained throughout the process. The updated policies and procedures should be sufficient to ensure that the process results in no real or apparent preferential treatment of any candidates and presents no significant disadvantage to floor nominees.

The guidance in this bookletter in no way lessens FCA's expectations regarding an institution's duty to remain impartial in director elections. As such, FCA will examine each institution's policies, procedures, and actual practices against the principles of fairness, equal access, and impartiality toward all candidates.

Please contact Andrew D. Jacob, CFA, Director, or Gary Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, at (703) 883-4414, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov if you have any questions regarding this communication.

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[1]FCA regulation § 620.21(d)(6) requires that candidate disclosure information be provided to voting stockholders as part of the election process. Candidate disclosure statements, prepared by all director candidates, consist of the candidate's name, city and state of residence, 5-year business and employment history, a list of other business affiliations where the candidate serves on the board or in a position of authority, familial relationships with the institution, and adverse loan status, if any, for any institution loan held by the candidate.

[2]Available at www.fca.gov.

Copy to: The Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

Type: Bookletter
Section Number: BL-058
Section Title: Financing Agricultural Land in Transition (in the Path of Development) -- Eligibility and Scope of Financing Considerations
Old/Additional ID: [Old/Additional ID]

May 28, 2009

To: Chairman, Board of Directors
All Farm Credit System Institutions

Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Financing Agricultural Land In Transition (in the Path of Development) – Eligibility and Scope of Financing Considerations

This Bookletter provides guidance on how institutions should ensure compliance with the eligibility and scope of financing regulations when loan funds will be used to purchase or refinance land in transition. Land in transition is agricultural land that lies in the path of development. In some cases, this may involve land changing ownership several times before ultimately transitioning out of agriculture. Questions frequently arise concerning the application of eligibility and scope of financing regulations when evaluating an applicant's request for financing. While financing land in transition may occur, the Farm Credit Administration (FCA) has consistently directed that Farm Credit System (FCS or System) institutions may not provide development financing that converts agricultural land to non-agricultural uses, except in very rare instances.

This Bookletter also provides useful information for making other scope of financing decisions and supplements the guidance found in the Examination Bulletin FCA 2006-2. The Examination Bulletin was developed to provide examiners guidance for evaluating programs that System institutions use in meeting the other (i.e., non-agricultural) credit needs of farmers, ranchers, and producers or harvesters of aquatic products.

It is important to note that neither Examination Bulletin FCA 2006-2 nor this Bookletter were developed to address the safety and soundness risks associated with financing land in transition. The FCA plans to issue further safety and soundness guidance in this area in the near future.

Eligibility and Scope of Financing Rules

The eligibility and scope of financing rules contained in 12 C.F.R., Part 613, Subpart A, address System funding for farmers, ranchers, and aquatic producers or harvesters. More specifically, § 613.3005 addresses the System's lending objective and provides parameters for financing the agricultural and non-agricultural needs of full- and part-time farmers (see Attachment). These parameters primarily focus on the applicant's status as a full- or part-time farmer, which is determined by analyzing the totality of the farmer's existing operation and the impact of the loan request. After a System institution has completed the eligibility analysis, it is able to determine the appropriate scope of financing (i.e., amount and type) that can be offered.

Section 613.3005 of FCA's regulations specifically notes that System institutions should only finance the agricultural credit needs of an applicant "whose business is essentially other than farming." However, the factors for making these determinations are not always readily apparent, making these determinations challenging – particularly when land in transition is involved. Accordingly, this Bookletter serves to provide additional guidance for determining whether an applicant's business is essentially other than farming; whether the property purchased is agricultural land; and whether the purpose of the loan request meets an agricultural need.

Policy Guidance – Controls Over Financing Land In Transition

Scope of financing determinations must be evaluated on a pro forma or "forward looking" basis. In other words, an institution's lending staff should determine what the applicant's operation would look like if the loan is approved and funded. Therefore, System institutions should ensure their lending policies and procedures require that the following determinations be made prior to financing land in transition:

- Is the person (i.e., an individual, or a legal entity, which may comprise multiple owners) applying for the loan a full- or part-time farmer or an applicant "whose business is essentially other than farming?"

- Will the property being purchased with the loan proceeds (or refinanced) continue to meet the regulatory definition of "agricultural land?"[1]

- Will the purpose of the loan fulfill an "agricultural need?"

To help guide these determinations, the following sections outline more specific guidance in evaluating the person, property, and purpose.

Analysis of the Person

As previously noted, § 613.3005 requires that a lender make a determination about an applicant's involvement in agriculture before financing a request for credit, including those involving land in transition. An institution's eligibility and scope of financing policies and procedures should address the following considerations in making this determination:

- An appropriate and supportable definition for an "applicant whose business is essentially other than farming" should be consistently applied. Factors to consider when developing this definition include the applicant's:

  - Percentage of farm income to nonagricultural income;

  - Percentage of time devoted to the vocation of farming or ranching;

  - Percentage of agricultural assets to nonagricultural assets;

  - Education, work experience, and current employment situation; and,

  - Past experience converting land from agricultural use to residential and commercial uses.

- A close evaluation of the factors used to determine if the applicant is a person "whose business is essentially other than farming" is needed. The more tenuous an applicant's ties to farming, the greater the need for justification and supporting documentation for land-in-transition financing decisions.

- If the applicant is a person "whose business is essentially other than farming" and is involved in land development, loan approvals should be on an exception basis and only after the institution determines that the loan purpose clearly meets an agricultural need. (See **Analysis of the Purpose** section below.)

- A careful evaluation of loan requests from an existing or former borrower is needed to determine whether the applicant's operations have evolved into land development ventures. If so, appropriate scope of lending determinations must be made before any future loans can be made.

Analysis of the Property

Section 619.9025 of FCA's regulations defines agricultural land as "land improved or unimproved which is devoted to or available for the production of crops and other products such as but not limited to fruits and timber or for the raising of livestock." Determining whether the property being purchased (or refinanced) meets this regulatory definition is important in establishing the eligibility and scope of financing for an applicant. To aid in making this determination, an institution's eligibility and scope of financing policies and procedures should address the following factors:

- System institutions should carefully evaluate any application that involves a request to finance real estate in close proximity to an urban area where high per acre land values are driven by the land's future development value rather than its agricultural value.

- Financing for the purchase or refinance of land in transition for an applicant "whose business is essentially other than farming" is appropriate only when all or substantially all of the land will continue to meet the definition of agricultural land.

- FCS institutions must fully understand and document what an applicant intends to do with the property financed (or refinanced). Any indication the land will no longer be available for the production of crops or other agricultural products should remove the property from consideration as "agricultural land."

- FCS institutions must thoroughly analyze and document the overall agricultural nature of a property. Land that will be used for both agricultural and non-agricultural purposes would only meet the regulatory definition of agricultural land when the land substantially retains its agricultural nature.

- Although zoning laws vary across the country, a review of the designation (i.e., agricultural, residential, or commercial) can help an institution determine whether a property should be considered "agricultural land."

Analysis of the Purpose

An analysis of the purpose of the loan is critical to evaluating financing for less than full-time farmers. FCS institutions must fully analyze and document to what extent the loan will fulfill an agricultural need.

This analysis is critically important once an FCS institution has determined that an applicant requesting a loan for land in transition is a person “whose business is essentially other than farming.” An institution’s eligibility and scope of lending policies and procedures should address the following issues to help lending staff make these determinations:

- FCS institutions must fully understand and document what the applicant plans to do with the property. The documentation provided by the applicant and developed by the loan officer should clearly explain and support why the loan is for an agricultural need. The institution may require that the applicant(s) sign a “statement of intent” to document future plans for farming or improving the real estate in question. Nonetheless, having a signed “statement of intent” does not eliminate the institution’s responsibility to perform and document a thorough evaluation of the application based upon the totality of the circumstances (i.e., the person, property, and purpose of the loan).

- System financing of residential or commercial development projects should only be done as a policy exception, with most, if not all, exceptions reserved for full-time farmers, or upon rare occasions, those part-time farmers with significant agricultural activities, assets, and/or income. Policies should address the proper level of authority within the institution needed for granting exceptions and require periodic reporting of policy exceptions to the board or a board committee.

- System institutions should make sure that appropriate validations and controls are maintained to ensure that loan advances are not used to fund purposes associated with commercial or residential development.

- Loan terms and structures should reflect the applicant’s agricultural needs. For example, requests for loans that have minimal down-payment or amortization requirements, interest-only repayment schedules, and short-term balloon payments, may suggest that the applicant’s financing needs are not agricultural. When financing an applicant who is essentially other than a farmer or a part-time farmer whose real estate has a high probability of being developed, a System institution should structure the loan in a manner that provides for the institution to exit the relationship before any development occurs.

- Plans for repaying the loan should be consistent with the intended agricultural use of the property. For example, applicants that propose loan repayment from the sale of real-estate collateral or other real-estate properties may be indicating that their needs are not agricultural. Further, if projected agricultural income is minimal compared to the loan repayment terms, this may suggest that the loan does not fulfill an agricultural need.

- FCS institutions should carefully evaluate any improvements that an applicant plans to make to a property. Improvements that enhance an agricultural operation (e.g., drainage tiling, fencing, irrigation) are considered to be agricultural purposes, while improvements that enhance the property’s non-agricultural appeal are considered non-agricultural purposes (e.g., paved roads, street lights, utilities).

- FCS institutions should carefully scrutinize any plans to divide a property into smaller parcels. The purchase of a large tract of agricultural land and its division into smaller agricultural tracts may be consistent with an agricultural purpose under certain very limited circumstances. As noted above, use of the property must remain predominantly agricultural and development on the property must be kept to a minimum for the loan purpose to be considered as fulfilling an agricultural need.

Decisions Based on the Totality of the Circumstances

System institutions must ensure that their policies and procedures provide adequate guidance to lending staff for the analysis of eligibility and scope of financing determinations. The analysis supporting these determinations should be documented and encompass the totality of the circumstances surrounding the loan request, including the person, property, and purpose as outlined above.

In conclusion, the guidance contained in this Bookletter does not prevent a board of directors from establishing conservative policy direction for land-in-transition financing. Each FCS institution board of directors needs to continue to evaluate its policy direction in consideration of their institution's current lending environment, risk bearing capacity, and appropriateness of land-in-transition financing for its chartered territory.

Please distribute copies of this Bookletter to your board of directors, discuss its contents, and make adjustments, as appropriate, to your policies and procedures as discussed above.

If you have any questions about the guidance contained in this Bookletter, please contact Barry Mardock, Associate Director, Office of Regulatory Policy, at (703) 883-4456 (mardockb@fca.gov), or Andrew Jacob, Director, Office of Regulatory Policy at (703) 883-4356 (jacoba@fca.gov).

Attachment

[1] See 12 C.F.R. § 619.9025.

Attachment

PART 613 - ELIGIBILITY AND SCOPE OF FINANCING

Subpart A - Financing Under Titles I and II of the Farm Credit Act

§ 613.3005 Lending objective.

It is the objective of each bank and association, except for banks for cooperatives, to provide full credit, to the extent of creditworthiness, to the full-time bona fide farmer (one whose primary business and vocation is farming, ranching, or producing or harvesting aquatic products); and conservative credit to less than full-time farmers for agricultural enterprises, and more restricted credit for other credit requirements as needed to ensure a sound credit package or to accommodate a borrower's needs as long as the total credit results in being primarily an agricultural loan. However, the part-time farmer who needs to seek off-farm employment to supplement farm income or who desires to supplement off-farm income by living in a rural area and is carrying on a valid agricultural operation, shall have availability of credit for mortgages, other agricultural purposes, and family needs in the preferred position along with full-time farmers. Loans to farmers shall be on an increasingly conservative basis as the emphasis moves away from the full-time bona fide farmer to the point where agricultural needs only will be financed for the applicant whose business is essentially other than farming. Credit shall not be extended where investment in agricultural assets for speculative appreciation is a primary factor.

Type: Bookletter
Section Number: BL-059
Section Title: Determining Eligibility and Scope of Financing for Limited Liability Companies
Old/Additional ID: [Old/Additional ID]

July 9, 2009

To: Chairman, Board of Directors
All Farm Credit System Institutions

Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Determining Eligibility and Scope of Financing for Limited Liability Companies

The purpose of this Bookletter is to provide answers to frequently asked questions about eligibility and scope of financing for a limited liability company (LLC). An LLC is a common legal entity being used today by America's farmers and ranchers for various reasons, including risk management and tax and estate planning. LLCs are often established by farmers and ranchers to maintain legal separation of their agricultural and nonagricultural businesses. As a result, the Farm Credit Administration (FCA or Agency) continues to receive questions regarding application of the eligibility and scope-of-financing rules to LLCs. The following *Questions and Answers* provide guidance in this area.[1]

What is a limited liability company?
An LLC is a state-chartered business entity that combines certain characteristics of a corporation and a partnership. Like a traditional corporation, the LLC structure limits the liability of its owners; like a partnership, it provides for pass-through income taxation. As in a corporation, an LLC's owners'/shareholders' personal assets are protected from claims of the LLC's creditors. Under state law, an LLC is generally considered to be a separate legal entity or "person" that can sue and be sued in its own name.

Can an LLC be an eligible borrower?
Yes. An LLC can be an eligible borrower. Under FCA rule § 613.3000(a), an LLC (and other legal entities) can qualify as a "person" eligible for financing as a "bona fide farmer or rancher" if it owns agricultural land or is engaged in the production of agricultural products, including aquatic products under controlled conditions.

Is an LLC treated like an individual for determining its eligibility and scope of financing?
Yes. An LLC is treated just like an individual for determining its eligibility and scope of financing because an LLC is considered to be a "person" for eligibility determination. Just like an individual farmer, an LLC must own agricultural land or engage in the production of agricultural products to be eligible to borrow from the Farm Credit System (System). As with any eligible borrower, determining the scope of financing depends on the level of the LLC's agricultural involvement in accordance with the scope-of-lending rule at 12 C.F.R. 613.3005.

Can an LLC formed for nonagricultural purposes borrow from the System?
It depends. An LLC that owns agricultural land but was not formed for the purpose of farming or ranching would be considered an applicant "whose business is essentially other than farming." Under § 613.3005, if an LLC's business is "essentially other than farming," financing is restricted to "agricultural needs" only. An agricultural "need" would not include developing agricultural land for residential or commercial purposes, and it would not include other nonagricultural business activities or other types of nonagricultural loan purposes.

However, if an LLC planned to purchase agricultural land and devote it to, or maintain its availability for, agricultural production, financing the purchase of the land would be considered an agricultural "need" and the LLC would be eligible to receive financing for this purpose. In this instance, just like with individual farmers whose businesses are "essentially other than farming," the loan should be structured to require it to be paid off at such time that the LLC decides to develop or use the land for a nonagricultural purpose. See FCA Bookletter BL-058, dated May 28, 2009, for additional guidance on financing land in transition.

Could an LLC receive financing for "other credit needs"?
Yes. Just like an individual farmer, if an LLC qualifies under an institution's lending policy and FCA regulations as a "full-time farmer," the LLC can receive other credit needs financing for any constructive purpose, commensurate with its creditworthiness. An LLC qualifying as a "part-time" farmer also could receive other credit needs financing, commensurate with its level of agricultural involvement. However, as stated earlier, an LLC whose business is "essentially other than farming" would not be eligible for other credit needs financing. Please refer to Examination Bulletin FCA 2006-2 for FCA's expectations regarding lending programs for farmers' other credit needs.

For determining eligibility for agricultural credit, does it matter that an LLC is owned by farmers, nonfarmers, or a mix?
No. Ownership of an LLC is of no consequence in determining eligibility when the LLC's purpose and needs are agricultural. For example, an LLC formed for the purpose of operating a crop farm would be eligible for System financing regardless of whether it was owned by farmers, non-farmers, or any combination thereof. However, as stated previously, an LLC whose purpose and only financing "need" is nonagricultural is not in itself eligible to borrow from the System.

Can a farmer's nonagricultural business interests be financed in an LLC?
Yes. A farmer may receive credit that will be used by a nonagricultural LLC, but only if the farmer-owner signs as an obligor on the promissory note. In this instance, the loan would be considered as a loan to the farmer, and the activities of the LLC would constitute the farmer's "other credit needs." The caveat, of course, as noted above, is that "other credit needs" financing must be commensurate with the farmer's involvement in agriculture and his or her creditworthiness. Without the farmer's signature, the association would be extending credit to an ineligible borrower, in violation of FCA regulation § 613.3000. While the farmer's signature on the promissory note addresses eligibility requirements, institutions must ensure that loans to the LLC are structured and underwritten in a safe and sound manner. Loans to the LLC should be underwritten with credit standards and requirements commensurate with the type of business activities and business risks undertaken by the LLC.

Would a 100 percent guarantee by a farmer on a loan to a nonagricultural LLC equate to a farmer signing as an obligor for determining eligibility?
No. We do not consider a guarantee to be the equivalent to the farmer signing as an obligor for the loan. While a guarantee can help ensure safe and sound lending, it does not provide a direct legal contract with the farmer for establishing borrowing eligibility on behalf of an LLC.

Can "farmer ownership tests" used for loans to legal entities formed for processing and marketing operations be used for determining eligibility and scope of financing for an LLC as a farmer-borrower under § 613.3000?

No. The "farmer ownership tests" under FCA regulation § 613.3010 for determining the eligibility of legal entities are only applicable to loans for processing and marketing operations. When determining the eligibility for a legal entity under § 613.3000 and the eligibility and scope of financing for an LLC outside of processing and marketing operations, one must look to the LLC itself, not to the owners of the LLC, as previously discussed.

Conclusion

In summary, an LLC is treated as a separate entity and as a separate "person" for purposes of determining eligibility and scope of financing. The owners of the LLC do not affect the LLC's eligibility or its scope of financing limitations under FCA regulation § 613.3000. The LLC itself may qualify as a "full or part-time farmer, or a person whose business is "essentially other than farming" and the scope of financing, including "other credit needs" financing, would then be determined commensurate with the LLC's involvement in agriculture and creditworthiness. In order for an association to make a loan to a farmer that would be used by a nonagricultural LLC, whose purpose and "need" are nonagricultural, the farmer-owner must sign as an obligor on the promissory note. Under such an arrangement, the activities of the LLC would constitute the farmer's "other credit needs." Additionally, the amount of "other credit needs" financing should be commensurate with the farmer's involvement in agriculture and creditworthiness. Please refer to Examination Bulletin FCA 2006-2 for FCA expectations regarding lending programs for farmers' other credit needs.

While eligibility and scope of financing issues can be effectively addressed by following the guidelines discussed in this Bookletter, an institution must also ensure that loans to LLCs are structured and underwritten in a safe and sound manner. Loans to an LLC should be conservatively underwritten with credit standards and requirements commensurate with the type of business activities and business risks undertaken by the LLC. Moreover, the institution must ensure that it has the appropriate staffing, controls, and policy framework to competently underwrite, understand, and control the risks associated with lending to an LLC.

Please distribute copies of this Bookletter to your board of directors, discuss its contents, and make adjustments, as appropriate, to your policies and procedures as discussed above.

If you have any questions about the guidance contained in this Bookletter, please contact Barry Mardock, Associate Director, Office of Regulatory Policy, at (703) 883-4456, or at mardockb@fca.gov, or Andrew Jacob, Director, Office of Regulatory Policy, at (703) 883-4356, or at jacoba@fca.gov.

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[1]This Bookletter does not apply to the financing of processing or marketing operations governed by FCA regulation § 613.3010 or to financing farm-related service businesses governed by FCA regulation § 613.3020.

Type: Bookletter
Section Number: BL-060
Section Title: Compensation Committees
Old/Additional ID: Technical Update—May 6, 2014: Regulation cites and FCA contacts

July 9, 2009

(Technical Update—May 6, 2014: Regulation cites and FCA contacts.)

To: Chairman, Board of Directors
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Compensation Committees

In recent months the matter of executive compensation has received significant attention from government officials, members of Congress, investors, the media, and the public. The administration is now developing enhanced guidance on compensation practices at U.S. banking organizations. Compensation practices, if not managed carefully, carry significant reputation risks to Farm Credit System (System) institutions as government-sponsored enterprises (GSEs). System institutions' boards of directors and their compensation committees must ensure that they are prudently managing compensation programs, aligning compensation practices with sound operations and long-term performance, and providing, in an open and transparent manner, accurate, comprehensive, and understandable disclosures on their compensation programs and practices as § 620.6 of FCA's regulations requires. These disclosures are vitally important to System shareholders, the investing public, and FCA.[1]

In 2006, FCA's governance rule required System banks and associations and the Federal Farm Credit Banks Funding Corporation (institutions) to establish compensation committees.[2] The regulatory requirement is relatively new. This bookletter advances the objectives of good governance by conveying our expectations for the compensation committee's fulfillment of its obligations to the institution and its shareholders. The compensation committee's sensitivity to the current business environment and its prudent management of the institution's financial resources are essential in protecting the institution's reputation in the community and the marketplace. The committee's role is critical in safeguarding the institution's integrity at a time of heightened concern and scrutiny on executive compensation. Your board of directors should initiate an appropriate review to determine whether your compensation committee charter, your compensation committee's process and operations, and your institution's compensation disclosures align with our expectations or whether changes should be considered.

Board Responsibilities. A compensation committee will function more effectively when the committee charter clearly sets out the board's expectations on how the committee is to perform its duties. The board of directors must establish and maintain a compensation committee by adopting a written charter and appointing at least three directors to serve on the committee in accordance with § 620.31 and § 630.6(b) of FCA's regulations. In carrying out these responsibilities, the board should ensure that the charter:

- Delineates clearly the authorities the board is delegating to the compensation committee;
- Authorizes the compensation committee to hire, retain, and terminate external advisers and/or outside legal counsel needed to assist the committee in performing its duties. These professionals should work directly for, and report directly to, the committee and be independent of senior management (i.e., no personal or other professional relationships with senior management);[3]
- Authorizes the committee's direct access to any advisers that management uses on compensation programs or practices;
- Provides for the committee's easy and ready access to institution resources and personnel, particularly senior officers and managers with human resources responsibilities, to obtain needed information and gain the best overall understanding of the compensation program; and
- Requires the compensation committee to remain accountable, and report only, to the board.

The board should appoint one of the directors to chair the compensation committee. The board should also ensure that the committee members have no known or potential conflicts of interest with executive (senior) officers that could interfere with the committee members' exercise of independent judgment. Additionally, the board should be mindful of its policy on director training and revise it, if needed, to ensure that compensation committee members receive ongoing training from professionals on compensation trends and updates, including the tax, accounting, and legal implications of compensation programs. The training should provide a solid platform for the committee to evaluate and modify the compensation program with a competent and critical eye.

Compensation Committee Operations. The committee should have written procedures in place for its operations. The procedures should address the responsibilities of the committee chair, particularly the chair's role as the key contact between the committee and the board and between the committee and senior management. In that capacity, the committee chair should have discretion to brief the board chairman and advise him or her of any key decisions in advance so the board is prepared to deal with the issue(s) when the committee and board meet. The procedures should provide for committee executive sessions where critical issues can be discussed without management present. By regulation, the committee must keep meeting minutes and retain those minutes for at least 3 years. Meeting minutes should provide sufficient detail on reasons for decisions to avoid member disputes on prior decisions. Committee members should have ready access to past minutes for reference or review. If the entire board serves as the compensation committee, it is essential that directors, when meeting as the compensation committee, maintain a separate agenda and a separate set of minutes so the business of the board and the business of the compensation committee are not mixed. The committee should review its charter annually and recommend any revisions to the board. As a subset of the annual board selfevaluation process, compensation committee members should consider assessing their own performance as a board committee.

Key Factors for the Compensation Committee to Consider in Discharging its Duties. The jurisdiction of the compensation committee includes the review of the compensation policy and plan for *all* employees as well as the approval of the overall compensation program for the chief executive officer and other senior officers. Thus, the committee's reach extends to the institution's salary programs, perquisites, short- and long-term incentives, deferred compensation, retirement and/or pension programs, supplemental pension programs for senior officers, executive employment and severance agreements, change-of-control provisions, succession planning and retention bonuses, and employee benefit plans. Consequently, we expect that the compensation committee should be able to:

- Articulate the board's compensation philosophy—what the institution rewards and why—and convey that philosophy in the annual compensation disclosure;
- Consult with, or employ as needed, professionals and/or external legal counsel who are independent of senior management and who bring the necessary perspective and expertise to work directly with the compensation committee on compensation-related issues;
- Fully analyze and justify the long-term liability to the institution in developing compensation packages and fully understand the financial commitment and total cost to the institution. Use appropriate analysis and metrics to develop a complete understanding of the full effects of the compensation package as it pertains to the chief executive officer and individual senior officers (all the elements of annual pay, long-term pay, severance benefits, and all other compensation);
- Ensure an appropriate linkage of pay to performance to ensure that total compensation packages are meaningful relative to the institution's long-term financial outcomes;
- Carefully evaluate incentive programs and ensure that incentive payments are based on the institution's long-term financial performance, are consistent with prudent risk-taking, and produce safe and sound outcomes;
- Ensure incentive programs align the interests of senior officers and employees with the long-term financial health of the institution (e.g., do not give undue weight to factors such as loan growth without also considering asset quality, profitability, and financial performance factors);
- Ensure that retirement benefits are appropriate and not excessive in light of bonus programs and other compensation already paid to executive officers;
- Ensure pension programs are appropriately structured to attract, retain, and reward staff, and that pension programs are appropriately funded; and
- Fully understand key assumptions used to calculate compensation and pension plan obligations, such as assumptions used for present value calculations, as well as the sensitivity of your institution's financial exposure to such assumptions.

Communication and Collaboration. The compensation committee needs to communicate and collaborate effectively with the chief executive officer. The compensation committee must also communicate regularly with other senior officers and managers (particularly those with human resources or risk management responsibilities) so that the flow of information between the committee and management is not impeded. Because of the complexity of compensation arrangements, committee members are expected to challenge management and the committee's external advisers on any compensation issue that they do not understand. The FCA also expects the compensation committee to provide prompt notice to FCA of any material changes in the institution's compensation program and to then disclose this information to the institution's shareholders in a timely manner.

Disclosures and Transparency. Section 620.6 of FCA's regulations details the compensation information that must be disclosed in the annual reports of System banks and associations.[4] FCA expects the compensation committee to review the compensation discussion and analysis to determine whether it meets the regulatory requirements of § 620.6 and whether the discussion is prominent, inclusive, and understandable. The board of directors and its compensation committee should not rely on the qualified public accountant for review of the compensation disclosure because such a review is not generally within the scope of the audit of the financial statements. The critical question for the compensation committee is whether the committee's decisions with respect to compensation matters are sufficiently transparent so that the reader of the disclosure understands the institution's compensation philosophy and practices.

FCA Oversight. FCA will continue its oversight of the conduct and operation of System institutions' compensation committees and the process by which the institutions develop compensation disclosures for reporting purposes. FCA will also take appropriate steps to ensure that full disclosure of compensation programs occurs.

In conclusion, System shareholders and investors in System securities are watchful of how the boards of directors, through their compensation committees, are carrying out their fiduciary obligations, both individually, to their respective shareholders and, collectively, to their investment community. This is evidenced by the institutions' annual published disclosures on executive compensation and compensation programs and the Systemwide report to investors. As a collective of farmer-owned cooperatives, the System holds a unique and distinguished position in agricultural financing and plays an increasingly significant role in lending to agriculture and rural America. It is essential that the System remain safe, sound, and financially strong, so it is there for America's next generation of farmers, ranchers, cooperatives, and rural communities. To ensure this outcome, System institutions must remain accountable to their respective shareholders, maintain strong governance practices, and demonstrate financial prudence in their decisions, including those on executive compensation.

If you have any questions regarding this communication, please contact your institution's examiner in charge or you may contact Gary K. Van Meter, Director, or Barry F. Mardock, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, at (703) 883-4414, or by e-mail to vanmeterg@fca.gov or mardockb@fca.gov.

Copy to: Chief Executive Officer

Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

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[1]Under section 514 of the Farm Credit Banks and Associations Safety and Soundness Act of 1992, Pub. L. 102-552,106 Stat. 4102 § 514 (1992), FCA must ensure that the financial disclosures (including disclosure of compensation) by System directors, officers, and employees provide (1) the institutions' shareholders with information they need to make informed decisions regarding System institutions' operations, and (2) investors with information they need to make decisions on purchasing System debt. FCA monitors, examines, and regulates the financial disclosures of all System institutions to ensure accurate reporting and disclosure occurs.

[2]Under § 620.31 of FCA's regulations, each bank and association board of directors must establish and maintain a compensation committee by adopting a written charter that describes the committee's composition, authorities, and responsibilities. Under § 630.6(b) of FCA's regulations, the Federal Farm Credit Banks Funding Corporation must also establish and maintain a compensation committee.

[3]Section 620.31(c) of FCA's regulations requires each bank and association to provide monetary and nonmonetary resources so the committee can function effectively. Section 630.6(b)(3) of FCA's regulations has a comparable requirement for the Federal Farm Credit Banks Funding Corporation.

[4]Associations have the option of disclosing this information in their Annual Meeting Information Statements.

Type: Bookletter
Section Number: BL-061
Section Title: Rural Housing Mortgage-Backed Securities
Old/Additional ID: [Old/Additional ID]

November 12, 2009

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit System Banks

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Rural Housing Mortgage-Backed Securities

The Farm Credit Administration (FCA) authorizes Farm Credit System (System) banks to hold rural housing mortgage-backed securities (RHMS) as mission-related investments under § 615.5140(e) of FCA's regulations, subject to the conditions specified below.

System associations may originate rural home loans (RHLs) that meet certain criteria under § 613.3030 of FCA's regulations.[1] Under § 613.3030(d)(1), a System bank is authorized to purchase and hold RHLs in an amount not to exceed 15 percent of its total outstanding loans at any one time. Under existing authorities, a System bank may opt to hold the RHLs until maturity. In addition, if the RHLs qualify, a System bank has the authority to take one of three other actions with respect to the RHLs. First, the System bank can have its RHLs securitized into RHMS that are guaranteed by Farmer Mac for the purposes of managing credit and interest rate risk and furthering its mission of financing agriculture, up to 100 percent of its total outstanding loans, pursuant to § 615.5174.[2] Second, a System bank can have its RHLs securitized into RHMS that are guaranteed by Ginnie Mae,[3] Fannie Mae, or Freddie Mac as eligible investments pursuant to § 615.5140.[4] Third, the System bank can enter into a long-term standby commitment to purchase (standby agreement) with one of the government-sponsored enterprises (GSEs). Under a standby agreement, a System bank can opt to (1) sell the RHLs to the GSE for cash or (2) have its RHLs securitized into RHMS that are guaranteed by the GSE.

Under §§ 615.5132 and 615.5140(a)(5) of FCA's regulations, a System bank may hold any government- or GSE-guaranteed RHMS for the purpose of complying with its liquidity reserve requirement, managing surplus short-term funds, and managing interest rate risk. The FCA is issuing this bookletter to authorize System banks to also hold RHMS as mission-related investments under § 615.5140(e) for the purpose of addressing liquidity needs in the rural housing mortgage market, subject to the following conditions:[5]

1) RHMS must meet the definition of "mortgage securities" as defined in § 615.5131 of FCA's regulations.
2) The RHLs underlying RHMS must be eligible rural home loans originated by System associations under § 613.3030.

3) Investments in RHMS must be fully guaranteed by the United States (e.g., Ginnie Mae), Fannie Mae, or Freddie Mac with terms of no more than 30 years.
4) The aggregate amount of RHMS that a System bank can hold at any one time may not exceed 15 percent of the bank's total outstanding loans. All RHLs made by System associations that have been purchased by the System bank and remain on its books must also be included in this limit. This limit is independent of any current regulatory portfolio limitations for investments in mortgage securities under §§ 615.5132, 615.5140(a)(5), and 615.5174 of FCA's regulations, or other mission-related investment limit.
5) RHMS must be maintained in a portfolio separate from other investments so that they are readily identifiable.
6) RHMS must be prudently managed in accordance with the System bank's investment policies.
7) RHMS must be reported in accordance with generally accepted accounting principles.
8) RHMS must be excluded from the liquidity reserve requirement under § 615.5134 of FCA's regulations.

In implementing this authority to hold RHMS as mission-related investments, we expect each System bank to follow prudent risk management practices such as establishing appropriate board approved exposure limits to the housing GSEs and the housing sector. We also expect each System bank to monitor these exposures through its ongoing credit oversight program. If you have any questions regarding this bookletter, please contact Andrew D. Jacob, Director, Office of Regulatory Policy, at 703-883-4356 or via email at jacoba@fca.gov or Laurie Rea, Associate Director, Office of Regulatory Policy, at 703-883-4232 or via email at real@fca.gov.

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[1]Section 613.3030 implements the rural housing financing provisions at sections 1.11(b) and 2.4(b) of the Farm Credit Act of 1971, as amended.

[2]RHMS guaranteed by Farmer Mac are not within the scope of this bookletter.

[3]Ginnie Mae (Government National Mortgage Association) is a wholly owned U.S. government corporation.

[4]Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) are housing GSEs.

[5]All references to RHMS in these conditions refer to RMHS that are backed by rural home loans originated by System associations and are held as mission-related investments.

Type: Bookletter
Section Number: BL-062
Section Title: Evaluating Strategies and Risks for Loan Pricing and Structure
Old/Additional ID: [Old/Additional ID]

May 13, 2010

To: Chairman, Board of Directors
Chief Executive Officer
Chairman, Asset/Liability Management Committee
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Evaluating Strategies and Risks for Loan Pricing and Structure

This bookletter provides guidance for the pricing and structure of loans to ensure appropriate earnings performance. Earnings performance is critical to the viability of a Farm Credit System (System) institution as it is the first line of defense against loan losses and the erosion of capital. Accordingly, investors in System debt and the rating agencies view System earnings and profitability as a major component of the System's financial stability. Conversely, declines in earnings performance can adversely impact the System's ratings and/or increase the cost of funding.

Background

The System generates the majority of its earnings from loans. Therefore, strategies for loans, including loan pricing, structure, funding, liquidity, and risk management, play a fundamental role in the earnings performance of a System institution. Appropriate loan pricing and structure decisions are particularly critical during volatile economic times, as recently experienced and likely to occur again in the future. Sufficient earnings help maintain the System's strong bond ratings and its reputation with investors, enable it to serve its mission, and ensure member owners benefit from their System cooperative.

Section 1.1(c) of the Farm Credit Act of 1971, as amended (Act), requires System institutions to provide equitable and competitive interest rates–taking into consideration a borrower's creditworthiness, access to alternative sources of credit, cost of funds, cost of servicing, and the need to retain earnings to protect borrowers' stock. Further, the Act states that in no case is any borrower to be charged a rate of interest that is below competitive market rates for similar loans made by private lenders to borrowers of equivalent creditworthiness and access to alternative credit. Therefore, properly pricing for risk in individual loans is critical to determining whether an institution is pricing loans consistent with rates available in the marketplace for loans that present similar risk characteristics.

Guidance

This bookletter communicates critical factors each System institution should consider when developing loan pricing and structure strategies. These strategic responsibilities reside with the board, but are typically administered by the institution's asset/liability management committee (ALCO). As discussed in FCA bookletter BL-012, dated January 15, 1991, all System institutions should have an asset/liability function administered by an ALCO as a critical component of its management system.

Due to the significant impact of loan pricing and structure on System institutions' earnings capacity, and to ensure consistency with the institutions' business plan goals in the current operating environment, System institutions' boards should continue to evaluate their direction and control over pricing and structure decisions. System institutions should manage loan pricing and structure using strategies that are well-developed, documented, and available for board and regulatory review. Boards of directors and senior management should review the institution's portfolio strategy periodically and should increase the frequency of review if the operating environment or portfolio mix warrants additional attention.

FCA regulations require System institutions to adopt written standards for prudent lending and written policies and procedures for prudent credit and loan pricing and structure practices. Specifically, when establishing and reviewing loan pricing and structure policies, procedures, standards, and practices, the FCA expects each System institution to:

1. Ensure loan pricing and structure decisions are consistent with the board's portfolio strategy and business plan objectives.
2. Incorporate appropriate risk based premiums into differential loan pricing programs.
3. Ensure the loan product mix provides sufficient flexibility to adjust rates/returns.
4. Evaluate how loan pricing and structure practices are affecting loan portfolio salability/liquidity.
5. Ensure pricing on all loan products/structures appropriately considers credit risk over the term of the loan, including the uncertainty of credit conditions in future periods.
6. Evaluate whether pricing practices provide sufficient margins for patronage and/or financial uncertainties of the institution.
7. Ensure loan pricing and structure practices meet statutory and regulatory objectives.

In addressing these areas, your institution's ALCO should, at a minimum, consider and address the questions discussed in the attachment. FCA examiners will use this guidance to aid in the evaluation and discussion of loan pricing and structure practices with System ALCOs, audit committees, boards, and management teams.

If you have questions in regard to this guidance, please contact Barry Mardock, Associate Director, Office of Regulatory Policy, at (703) 883-4456, or at mardockb@fca.gov, or Tim Nerdahl, Policy Analyst, Office of Examination, at (952) 854-7151, ext. 5035, or at nerdahlt@fca.gov.

Attachment

Attachment

1. How are loan pricing and structure used to achieve portfolio strategies and business plan objectives?

Each System institution should establish business plan goals and related portfolio strategies considering the board's risk appetite, its lending environment and the need to meet the System's long-term mission to serve agriculture. Loan pricing and structure are the critical tools for achieving these goals and strategies. A portfolio strategy assesses the current composition of an institution's portfolio, evaluates the loan products that are currently offered, and then provides the board and management's vision of what the portfolio composition should look like in the future. For example, a System institution may see opportunities to diversify the portfolio through syndications and loan participations or changing the duration of the portfolio from long-term loans to more short-term loans or vice versa. The FCA considers the review and assessment by a System institution of its portfolio strategy to be a prudent business practice and an integral part of its business and capital planning process. Conversely, operating without a portfolio strategy could result in excessive portfolio concentrations and insufficient earnings performance levels in future periods.

A portfolio strategy developed as part of the business planning process should cause a System institution's board and management to ask critical questions regarding the institution's expertise and capital adequacy. For example, System institutions involved, or planning to become more involved, in capital markets/participation activity should proceed in a thoughtful manner after fully considering the following questions: 1) How well do we understand loan pricing and structure in this marketplace? 2) Do we have a solid strategy and do we truly have the expertise and experience necessary to engage in this business activity and conduct our own due diligence in a prudent and sound manner? 3) Are the terms and returns available in the marketplace for these loans consistent with our risk management objectives? 4) How much capital will be needed to support the risk associated with moving into these new products or types of loans? 5) What type of risk-adjusted return do we need to adequately compensate our shareholders for the risk taken? By asking these types of questions, management and the board can provide a clear assessment of what it will take to enter different markets and whether this business will contribute to the institution's overall success.

2. Do your pricing programs provide for sufficient risk differential?

System institutions should be compensated for the risk they are taking. Different loans present different risks, depending on variables including loan type, purposes, terms, collateral risk, amount, quality, and financial stability of the borrower. As a result, higher interest rates should be established for loans that expose an institution to more risk. A borrower whose loan is appropriately risk rated a 4 or 5 should generally pay a lower rate of interest than a similarly situated borrower whose loan is risk rated an 8 or 9 for the same product (if financed at the same time). Likewise, borrowers whose loans pose higher loss expectation in the event of default should also pay a premium compared to borrowers whose loans pose a low loss expectation in the event of default.

Differential or tier-based pricing programs are designed to ensure interest rates charged to borrowers reflect the inherent risk in specific loans or loan types. As provided for in FCA regulation § 614.4160, differential loan pricing allows System institutions to reflect the variances in costs associated with various loan products while ensuring that equitable rate treatments are achieved within categories of borrowers. Interest rates may be differentiated by risk factors (e.g., classification/risk rating, loss given default rating, or performance status), loan characteristics (e.g., size, enterprise, servicing costs, collateral risk, or credit factors), loan terms, geographic area, or a combination of factors. Often, stress testing helps to differentiate the underlying risk exposure of a loan under various economic scenarios, which can serve to ensure an institution is appropriately pricing a loan consistent with risk it represents.

The establishment of interest rates requires analysis of risk in the loan portfolio to determine whether spreads remain adequate given the level of risk in the particular loan or group of loans. Controls should be in place to ensure that loans are assigned differential rates according to established procedures and are reviewed to ensure proper assignment and recording. While pricing exceptions can be granted for competitive reasons, System institutions should monitor the rate of exceptions to ensure the integrity of the pricing program and achievement of earnings objectives. Loans should be reviewed periodically, at renewal, or as repricing opportunities arise, to assess performance and adherence to program criteria. Failure to make necessary adjustments can result in insufficient returns relative to the changes in risk exposure.

System institutions should establish a means whereby differential loan pricing practices and risk-adjusted returns are monitored on an ongoing basis. This allows a System institution to make adjustments if the return on a specific loan product is inadequate in relation to the institution's business plan goals and/or risk assumed. Boards should also monitor this type of information to remain informed about the institution's loan pricing practices.

Risk-adjusted pricing models should be used in the pricing process. These models can vary from relatively simplistic to more sophisticated models, such as economic capital and risk-adjusted return on capital models. At a minimum, these models should consider the cost of funding, option risks that are not eliminated through funds transfer pricing, allocated operating costs, expected and unexpected loan losses, and profit objectives. These models could also consider other factors, such as loan structure and the effects of diversification or concentration. Any pricing model is highly dependent upon underlying assumptions and historical information. As a result, institutions should have processes for accumulating this information and validating assumptions. The complexity of validation processes should vary in accordance with the complexity of the pricing model.

3. Do your loan pricing and structure practices provide sufficient flexibility to maintain stable earnings and protect capital?

System institutions, from time to time, will need to adjust their interest rates to generate sufficient earnings to protect capital. Interest rates and spreads that appear sufficient during strong economic times may prove to be insufficient during economic downturns and/or times when funding markets are volatile or access is otherwise restricted. System institutions should have strategies in place to evaluate whether their loan pricing practices will continue to meet earnings objectives during periods when the funding environment becomes more volatile, market interest rates are changing rapidly, and credit risk is increasing. An institution's pricing program should ensure that loan spreads are adequate to cover risk (including future allowance needs) and funding costs, and provide a sufficient return to capital throughout the term of the loan, including during a volatile operating environment. Use of differential pricing programs, economic capital models, market studies, and other risk analysis tools can be useful for ensuring appropriate pricing relative to risk in individual loans. System institutions should use such tools to evaluate whether their loan pricing and structure practices provide sufficient flexibility to adjust spreads and interest rates charged to borrowers. It is critical that System institutions make the tough decision to increase and maintain spreads when adverse conditions are expected or become evident in the institution's operating environment.

Many System institutions offer administered-rate loans in part because these loan products provide flexibility to increase rates or increase spreads when needed. Contractually, administered rates can be changed periodically regardless of changes in market rates. In theory, administered-rate loans provide the flexibility to increase spreads at any given time with proper notification. However, in practice, administered-rates might not be changed in a manner fully responsive to changes in market rates or risk conditions in the environment. Administered-rate changes can be unresponsive to market rate changes if institution boards and management are hesitant to change rates given concerns over membership reaction. Failure to adjust administered-rate loans in concert with market rates may result in unintended consequences for a System institution, such as reduced spreads and earnings performance. Accordingly, System institutions should have significant discipline and internal controls over administered rates to ensure needed rate changes are made in a timely and appropriate manner.

If priced and funded properly, a loan portfolio that contains a large volume of fixed-rate and/or indexed-rate loans should, over time, produce a relatively stable stream of earnings. However, if these loans are aggressively priced with thin spreads, they may produce, over time, a loan portfolio with insufficient margins to generate the earnings necessary to provide for loan losses and protect capital. System institutions with large concentrations in fixed-rate and indexed-rate loans can only adjust spreads by increasing rates on new loans and existing administered-rate loans, taking these institutions much longer to increase their overall portfolio profitability. In addition, System associations' transfer pricing programs with their funding banks may allow the bank to change spreads charged to its associations at any time. Consequently, spreads may compress on existing loans in the portfolio. Accordingly, an association's portfolio mix and pricing strategies should provide sufficient flexibility to ensure that the loan portfolio continues to provide sufficient returns under varying conditions.

4. How do your loan pricing and structure practices impact the liquidity of your loan portfolio?

To fully understand the impact of its loan pricing and structure decisions, System institutions should consider how their loan products would sell in the financial marketplace. While System institutions generally hold loans they originate, and the secondary market for agricultural loans remains a limited source of liquidity, institutions are encouraged to evaluate the market value of their loans. We recognize there are unique features to System loans that could impact their value and salability; however, we believe it is important for System institutions to determine the market value of their loan portfolios as a tool to measure how liquidity and capital strength are impacted by loan pricing and structure decisions. The various structures, lack of standardized market terms and covenants, and optionalities of the products offered can greatly impact a loan's salability and value in the marketplace. Loans that are structured in a way that could reduce salability should not have liquidity impacted further by insufficient pricing.

One way System institutions could evaluate portfolio salability is to periodically complete an analysis of the liquidity and market value of their loan portfolio. This analysis could include data supporting the marketability of the loan portfolio and expected market price that could be achieved. This analysis would keep management teams and boards informed on decisions resulting from their loan offerings and how these decisions have impacted earnings and liquidity of their institution. This information would then allow management to make adjustments needed to meet earnings and liquidity objectives.

5. When evaluating the risks associated with long-term loans, how do you ensure that they are appropriately priced and provide adequate compensation for the risks assumed?

Long-term loans pose unique risks that System institutions need to fully consider in pricing decisions. System institutions that index or lock in borrower interest rates for long periods of time may be protecting the borrower from rising interest rates, but may be under-pricing for the uncertain credit risk in future periods. Consequently, System institutions should ensure that interest rate spreads on long-term fixed-rate loans are sufficient to compensate for the additional risk being assumed over the life of the loan.

Risk in long-term loans emanates from the uncertainty of future economic events. In addition, institutions often find it difficult to obtain current information on the borrower's financial condition and performance and are typically unable to adjust loan pricing based on changes in the borrower's risk profile. Without updated financial information it is difficult to identify deterioration in credits prior to a customer missing a payment. To address this risk, many institutions make loans with 15- or 20-year amortizations with balloon payments due in 5 to 7 years. The balloon maturity provides an opportunity to revisit the borrower's risk profile. Loan documents, at a minimum, should be designed to obtain updated financial information when needed. Accordingly, System institutions should ensure that proper controls and/or pricing for long-term fixed-rate loans mitigate and/or compensate the institution for assuming this risk.

6. How do your patronage practices enter into loan pricing and structure decisions?

System institutions with sufficient earnings may reflect those earnings in making patronage payments to their customers or in offering more advantageous loan terms to their customers. Charging customers a rate up front that supports plans to pay patronage later can help ensure that System institutions have an earnings buffer in the event provisions for loan losses, in excess of business planning projections, become necessary. This additional flexibility and buffer for an institution is also recognized by investors in System debt securities. Investors tend to focus on the System's pre-patronage return on assets and equity, recognizing that institutions can lessen or defer patronage payments based on the needs of the institution. Nevertheless, System institutions that have a history of paying patronage refunds and then stop or lessen payments can experience borrower discontent as members come to expect patronage refund checks. Accordingly, System institutions should ensure that member/borrowers are fully informed that as a cooperative, the capital needs of the institution may take priority over the patronage needs of the membership during periods of economic stress.

Some System institutions offer more advantageous loan terms to their customers to compensate for not paying patronage. However, charging lower rates and achieving lower spreads on loan products may not provide for the additional earnings necessary for financial uncertainty. Financial uncertainty would include unplanned provisions for loan losses, capital erosion, and other unforeseen expenditures. In these cases, compensating strengths should be in place to mitigate financial uncertainty. Compensating strengths could include higher capital levels, a low operating expense rate, or the use of conservative underwriting standards and lending limits. Consequently, pricing programs that do not take into consideration the potential for financial uncertainty or possess compensating strengths can be considered unsafe and unsound.

7. How do your loan pricing and loan structure practices help meet your institution's statutory and regulatory service objectives?

An institution's portfolio strategy must provide for an adequate and flexible flow of funds into rural areas and provide competitive credit for farmers and ranchers. Chosen strategies must also accommodate the furtherance of statutory and regulatory service objectives. For instance, FCA regulation § 614.4165 requires System institutions to establish programs to provide sound and constructive credit and services to young, beginning, and small (YBS) farmers, ranchers, and producers or harvesters of aquatic products. As further discussed in FCA bookletter BL–040 Revised, such programs could include applying more flexible interest rates or fees, customized loan underwriting standards, loan guarantee programs or other credit enhancement programs. In addition, FCA regulation § 614.4160 states in the adoption of differential interest rate programs, institutions may consider, among other things, the effect that such interest rate structures will have on the achievement of objectives relating to the special credit needs of YBS farmers.

A sound portfolio strategy provides System institutions with the foundation to ensure that sufficient earnings and capital are in place to fully implement the System's statutory and regulatory service objectives. A critical component of that strategy is to have in place pricing and structure practices that ensure that credit is available, where and when it is needed most. Therefore, the critical factors discussed above must be considered in the context of the System's overall mission to provide sound and dependable credit to agriculture and rural America.

Type: Bookletter
Section Number: BL-063
Section Title: Farm Credit System Bank Merger Applications
Old/Additional ID: [Old/Additional ID]

July 8, 2010

To: Chairman, Board of Directors
Each Farm Credit System Institution

Chief Executive Officer
Each Farm Credit System Institution

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Farm Credit System Bank Merger Applications

This bookletter has been approved by the Farm Credit Administration (FCA or Agency) Board and communicates the Agency's expectations for the submission of proposals to merge Farm Credit System (FCS or System) banks.[1] The FCA Board recognizes that merger decisions primarily rest with System stockholders. However, given the complexity of issues that may result from bank mergers, the FCA Board also wants to ensure that merger applications identify and comprehensively address all the broad implications for the System and its institutions.

Mergers of FCS banks[2] may provide benefits and create risks for the merging banks, bank shareholders, the System as a whole and all eligible borrowers. Benefits of a bank merger may include portfolio and geographic diversification, improved risk-bearing capacity, management capability, and operational efficiencies. However, a bank merger may increase risk by creating a larger, more complex and difficult-to-manage institution. Such a bank may present broad risks to other System institutions. As discussed more fully below, when evaluating a bank merger application, the FCA will carefully consider the long-term impact on the safety and soundness at the institution, district, and System levels, including size concentration risk, business model compatibility, and intra-System operational risk. Of particular importance are the implications these risks may have on the System's long-term service to eligible borrowers and its continued ability to fulfill its mission as a government-sponsored enterprise (GSE). Therefore, the FCA expects bank merger applications to clearly and fully address:

- The risks that the larger bank would create for the continuing bank's shareholders and System as a whole, including the impact on the System's repayment of joint and several debt obligations and protections available to investors in System debt.
- How the resulting bank and the System would be structurally safe and sound for the long-term, including the long-term compatibility of the shareholder associations with the business philosophy of the bank.

- How the proposed merger furthers intra-System collaboration and coordination on intra-System operations, furthers the System's GSE mission, including service to eligible borrowers, and safeguards the American taxpayer in the financial performance and mission service of the System as a GSE.

Size Concentration Risk

During the 1980s and 1990s, with dramatic changes in the financial landscape, the System evaluated and implemented various alternative organizational structures to better position System institutions for providing financial products and services to agriculture. The various mergers, territorial realignments, transfers of direct lending authorities, and other organizational changes have resulted in a complex array of differently sized entities, overlapping territories and different business models. At the bank level alone, the number of institutions went from 37 in 1988 to 5 today, with 2 bank districts accounting for over 62 percent of total System assets. Future bank mergers would further concentrate System assets.

Size concentration risk is a significant safety and soundness issue that must be addressed in any bank merger application. The bank merger application must include an analysis of the size concentration risk being borne by the other banks, the System as a whole, and by investors in Systemwide debt obligations. For instance, concentrating assets and funding in a single bank's business model may unduly stress the Insurance Fund and the statutory joint and several liability of the remaining banks. To address size concentration risk, merger applications must identify needed risk mitigating controls such as stronger financial performance requirements, enhanced standards and obligations in intra-System agreements and, possibly, equalization through association re-affiliations, territorial adjustments, or other structural or financial approaches that could occur contemporaneous with the merger. As part of the analysis of size concentration risk, it is important that the merging banks consult with other banks on appropriate and acceptable risk mitigating actions and controls.

Business Model Compatibility

Bank mergers succeed or struggle based on the level of business model, cooperative philosophy, and operating practice compatibilities between the bank and its shareholder associations. Therefore, it is important for a bank and its affiliated associations to share business model compatibility in order to achieve long-term success. This compatibility is essential whether the bank is a limited-service, full-service, or mixed retail-wholesale bank. Successful integration into a cohesive bank district requires the long-term support of the resulting bank's affiliated associations and their respective boards and management teams. Given the risks posed by business model incompatibilities to the long-term financial and operating success of a bank, merger applications must identify and analyze the risks and provide practical approaches for addressing them. These approaches may include providing associations that have different philosophies the opportunity to re-affiliate contemporaneous with the merger. Alternatively, the bank may consider refining its business practices or governance structure to result in greater compatibility with the district business model, cooperative philosophy, and operating practices.

Intra-System Operational Risk

Associations' ability to serve eligible borrowers depends on the System's collaboration and coordination on various intra-System operational matters. For instance, associations rely, to varying degrees, on their funding bank, including bank support for needed loan products and related services, skill in obtaining cost-efficient funding, ability to limit interest-rate risk, and success in managing liquidity risk. Similarly, all banks work together to access the financial markets, coordinate on loan products and services, and on other matters.

A bank merger may concentrate significant influence, management decision making, and authority in the resulting bank. Therefore, bank merger applications must include: (1) an assessment of the impact that the merger will have on representation in various Systemwide decision-making and coordination bodies; and (2) identify any needed enhancements or new measures that ensure long-term cooperation across the System. Within the bounds of safety and soundness, the FCA wants to ensure that coordination and cooperation across the System continues to facilitate individual institutions fulfilling and furthering their statutory mission as GSEs. The FCA expects the merging banks to use a cooperative and collegial approach in addressing this issue by communicating with their respective shareholders and all System banks and associations in the process.

Conclusion

Open communication with the merging banks' respective shareholders and comprehensive disclosure are essential to fully identify and address these broad issues. Similarly, discussion and coordination with other System banks and their shareholders will be important in analyzing and addressing potential issues that may impact the System. FCA expects early and ongoing communication when banks are considering a possible merger, including an early review of the many potential agreements or arrangements needed to facilitate the process.

As we have done for association merger applications, the FCA intends to issue bank merger guidelines that describe the bank merger application process and list the specific information and documents that a bank merger application must contain. These bank merger guidelines well help facilitate comprehensive and complete bank merger applications.

Please contact Thomas L. Dalton, Associate Director, at (703) 883-4460 or daltont@fca.gov or Andrew D. Jacob, Director of the Office of Regulatory Policy, at (703) 883-4356 or jacoba@fca.gov, if you have any question regarding this bookletter.

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[1]Section 611.1020 of FCA's regulations states:

> Where two or more banks plan to merge or consolidate, the banks shall jointly submit to the Farm Credit Administration the documents itemized in §§ 611.1122(a)(1) through (4), (6), (7), 611.1122(e) and 611.1123. In interpreting those sections, the word "bank" shall be read for the word "association."

Section 611.1122(a)(7) requires that banks include in their merger applications any information or documents requested by the FCA in addition to the documents and information specified in the regulations.

[2]Subject to the FCA's approval, FCS bank mergers are authorized under sections 7.0 and 7.12 of the Farm Credit Act of 1971, as amended (Act).

Type: Bookletter
Section Number: BL-064
Section Title: Farm Credit System Investment Asset Management
Old/Additional ID: [Old/Additional ID]

December 9, 2010

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Farm Credit System Investment Asset Management

This bookletter has been approved by the Farm Credit Administration (FCA, we, our) Board. It applies to all Farm Credit System (System or FCS) banks or associations (institutions) that hold eligible investments for the purposes set forth in §§ 615.5132 and 615.5142 of FCA regulations.[1] It is intended to provide clarification and guidance regarding FCA's regulations and expectations with respect to the key elements of a robust investment asset management framework that each institution should establish to prudently manage its investments in changing markets.

Under § 615.5132, System banks may hold eligible investments for the purposes of maintaining a liquidity reserve, managing surplus short-term funds, and managing interest rate risk. Under § 615.5142, Farm Credit associations may hold eligible investments to reduce interest rate risk and to manage surplus short-term funds, subject to the approval of their funding banks. These purposes do not authorize System institutions to accumulate large investment portfolios for arbitrage or trading activities.

Section 615.5140(a) provides a list of eligible investments.[2] The regulation specifies appropriate asset classes, maturity limits, portfolio limits, obligor limits, and other requirements. Section 615.5140(c) requires that all eligible investments, except money market investments, must be marketable, stating that an eligible investment is marketable "if you can sell it quickly at a price that closely reflects its fair value in an active and universally recognized secondary market."

Section 615.5133 of our regulations establishes requirements for implementing an effective oversight and risk management process for investment activities and liquidity management.[3] Strong investment asset management begins with appropriate board and senior management oversight. The board of directors is responsible for establishing written investment policies that are appropriate for the size, types, and risk characteristics of its institution's investments. Investment policies are a critical aspect of effective risk management and should set appropriate limits on exposure to credit, market, concentration, and liquidity risks. Senior management is responsible for implementing board direction and ensuring that it is carried out.

During the prolonged period of financial stability that preceded the recent financial crisis, FCS institutions' investment management policies and allocation strategies were adjusted infrequently and investments were seldom subject to credit risk stress tests. Although the System has experienced considerably less investment stress during the crisis than many other financial institutions, both FCA and the System recognize that more frequent adjustments to investment management policies and allocation strategies and more frequent credit risk stress tests would have improved institutions' investment management processes and could have resulted in a higher quality, more liquid portfolio during the crisis. Accordingly, FCA expects, even during periods of stability, that each System institution will revisit its investment allocation strategies frequently (more than once a year), in order to manage asset concentrations that could increase its liquidity risk and impede its ability to convert investment positions to cash quickly, if needed. In addition, each institution should ensure it has the appropriate tools in place to evaluate credit risk during the purchasing process and on an ongoing basis.

Further, some System institutions invested in structured products, including private placements, in volumes representing high concentrations of capital. During the financial crisis, many of these securities became distressed and illiquid. As a result, these institutions experienced a significant deterioration in investment asset performance and quality which increased their liquidity risk profile during a period when market access was tenuous and stressed. In light of this experience, FCA expects an institution to use prudent investment asset management to ensure that the institution maintains a pool of highly liquid assets. In particular, the FCA expects the board and senior management of each institution to:

- Establish prudent policies, procedures, and internal controls to effectively oversee the institution's investment activities, including establishing appropriate delegations of authority, purchase and hold limits, segregation of duties, and reporting;

- Limit concentrations of risk in particular counterparties, asset classes, individual securities or tranches, sectors, and industries;

- Develop an appropriate independent credit analysis process that has reduced reliance on Nationally Recognized Statistical Rating Organization (NRSRO) credit ratings and that includes an evaluation of the underlying cash flows, price risk, and collateral under stressed conditions; and

- Ensure that all investments purchased meet FCA's regulatory definition of a "marketable" investment and that the institution establishes procedures and processes to evaluate the marketability and liquidity of the investment portfolio.

FCA examiners will use the guidance set forth in this bookletter in evaluating investment asset management practices and in discussing those practices with System asset liability management committees (ALCOs), audit committees, boards, and management teams.

The recent financial crisis and its lingering effects have re-emphasized the importance of sound investment and liquidity risk management practices by System institutions. Sufficient oversight by each System institution's board of directors and senior management is a critical control for prudent investment asset management. We recognize that the System banks have added high quality liquid assets to their investment portfolios to help ensure sufficient liquidity going forward. Institutions should expect FCA examiners to continue to closely evaluate risk management policies and procedures as well as investment portfolio composition, performance, and risks. In addition, the FCA Board plans to consider regulatory changes relating to eligible investment assets to ensure that prudent practices are in place for the safe and sound management of investment portfolios.[4]

If you have questions in regard to this guidance, please contact Laurie Rea, CFA, Associate Director, Office of Regulatory Policy, at (703) 883-4232, or at real@fca.gov, or Tim Nerdahl, Senior Financial Analyst, Office of Regulatory Policy, at (952) 854-7151, ext. 5035, or at nerdahlt@fca.gov.

Attachment

Attachment
Investment Asset Management

The topics discussed in this attachment address critical components of investment asset management. System institutions should address these items in their investment policies and practices to ensure adequate controls and governance are in place to manage risk, while achieving liquidity objectives and maintaining safety and soundness.

Effective investment asset management is founded on three fundamental pillars: Board and senior management oversight, risk management and measurement, and risk evaluation. The basic tenets of these pillars and FCA expectations are outlined and discussed below.

Pillar 1: Board and Senior Management Oversight

- Investment policies
- Board involvement
- Investment plan implementation
- Reporting to the board

Pillar 2: Risk Management and Measurement

- Effective internal controls environment
- Independent audit program
- Due diligence and modeling cash flows and assumptions
- Credit risk evaluation
- Pricing and valuation practices
- Evaluation of liquidity and market risk
- Enterprise risk management

Pillar 3: Risk Evaluation

- Assessment of current economic and financial conditions
- Identification of emerging risks
- Sector risk evaluation
- Stress testing

This attachment concludes by discussing the regulatory requirements for associations that engage in investment activities.

PILLAR 1 – BOARD AND SENIOR MANAGEMENT OVERSIGHT

Satisfactory investment asset management begins with board and senior management oversight of the investment activities of an institution. The board sets the direction for the institution through investment policies and the planning process. Senior management implements board direction and reports to the board in accordance with FCA regulations and board policy.

Investment Policies: Section 615.5133(a) of FCA regulations requires the board of each System institution to adopt written policies for managing its investment activities. The policies must address the purposes and objectives of investments, risk tolerance, delegations of authority, and reporting requirements.[5] In addressing risk tolerance, the policies must establish risk limits and diversification requirements for the various classes of eligible investments and for the entire investment portfolio.[6] Asset allocation and diversification strategies are important elements of prudent investment portfolio management. Investment policies should identify specific risk limits, as well as liquidity and diversification requirements that are consistent with the objectives, capital position, and risk tolerance of the institution.[7] The policies should specify the types and amount of investments in which the institution may invest, taking into account the eligible investments and regulatory maximums specified in § 615.5140.[8] The policy should also clearly identify the responsibilities and limits of committees that oversee investments.

In general, policies should incorporate the following principal elements:

- Purpose of the policy and objectives that are to be accomplished;
- Parameters within which management and staff are expected to operate;
- Authorities delegated to management and authorities retained for board approval or action;
- Process for addressing exceptions; and
- Reporting requirements.[9]

Furthermore, an institution's investment policies must be appropriate for the size, types, and risk characteristics of the institution's investments.[10] At a minimum, the board of directors must review these investment policies at least annually and make any changes that are needed.[11] The board must ensure that management complies with its investment policies and that appropriate internal controls are in place to prevent loss.[12]

Board Involvement: Board members are expected to take an active role in risk governance, including having an effective internal controls environment and ensuring that the institution complies with applicable laws and regulations. Among the effective ways for the board to exercise risk governance over the investment portfolio is through the annual planning process.[13] Through the planning process, the board should establish the institution's strategic investment direction and provide guidance to senior management on implementation of its approved investment policies and strategies. The board should approve business plan goals based on its objectives and the ongoing operational and liquidity needs of the institution. The board should also evaluate the institution's existing portfolio during the planning process, including the risk and returns generated by the portfolio. In addition, the planning process should provide direction as to the targeted composition of the portfolio, based on the institution's liquidity and operational needs, and risk tolerance.

Investment Plan Implementation: Once an institution's board provides investment direction through its planning process, management must develop approaches to implement this direction. FCA regulations do not prescribe specific implementation approaches. However, sound business practices include the development of a dynamic investment plan and the establishment of a formal investment committee.

An institution's senior management should develop a sufficiently detailed investment plan to appropriately execute the board's approved investment strategies and achieve business plan goals of the institution. The plan should be approved by senior management, or at a high level of management such as the ALCO or other appropriate management committees. The investment plan should help provide for effective guidelines and control over the investment portfolio. The plan could take many different forms, but it should be a dynamic working document that can deal with changes in market conditions. The plan should identify the current implementation strategies necessary to deal with changes in the investment portfolio that might be needed to address ongoing liquidity requirements and asset liability management objectives. This would require the investment management staff to document the current focus of the investment portfolio, noting changes from the previous reporting period. In addition, the plan should identify, among other items, the projected sources of incremental returns, sectors or security types in which the institution expects to invest, investment class and security hold limits, and counterparty concentration limits.

Key elements of an investment plan include the following:

- An appropriate target portfolio composition given the investment policy parameters, current market conditions, and liquidity needs;
- Rebalancing tactics to achieve the target portfolio allocation from the current allocation; and
- Performance measures including target portfolio spread given the target portfolio composition and anticipated various spreads in relation to the institution's cost of funds.

To effectively implement the investment plan, each institution should consider establishing a formal investment committee to provide additional expertise and serve as an additional control over investment asset management. In the past, the ALCOs, which oversee the management of investment portfolios in most System institutions, have generally provided sufficient oversight of these portfolios. However, while not required by FCA regulation, the importance, volume, and growing complexity of System investments may warrant additional expertise in the form of an investment committee. The committee should be involved with tactical investment decisions and overseeing the risks in investments. Moreover, the committee should ensure that the institution's credit department oversees and analyzes complex credit assets that are structured as investments. In addition to providing additional expertise, the investment committee would also provide for separation of duties between allocation and risk strategies and the actual traders. This committee would also provide appropriate monitoring and governance as well as provide structure or formalization of many of the informal processes.

An effective investment plan and an engaged investment committee provides the ALCO and the board with a better understanding of the institution's approach to current and future investment activities.

Reporting to the Board: Each quarter, management must report to its board (or committee thereof) on the performance and risk of each class of investments and the entire investment portfolio.[14] Furthermore, reporting must reflect significant events affecting the institution's investment environment.[15] In addition, reporting must address whether investments are achieving their objectives.[16] For example, if a class of investments was purchased for the objective of maintaining a liquidity reserve, then reporting must address liquidity characteristics of the investment class and the extent to which the investments contribute to meeting the liquidity objective. The board should also require periodic review and reporting through the internal audit program. Timely and quality reporting on investment activities is an important component of board and senior management oversight. Institutions that conduct investment activity should ensure that the nature and frequency of the reporting is appropriate for risk in the portfolio and the current environment.

PILLAR 2 – RISK MANAGEMENT AND MEASUREMENT

This section clarifies our expectations for how a System institution can strengthen its risk management and measurement practices. Managing and measuring the risk in investments are critical parts of effective investment asset management. Strengthening these practices should improve the institution's overall management with respect to its investment portfolio. This section discusses an effective internal controls environment and the role of audit. In addition, this section discusses due diligence and the modeling of cash flows and assumptions, credit risk evaluation, pricing and valuation practices, and the evaluation of liquidity and market risk. Furthermore, this section discusses effective enterprise risk management practices that institutions need to recognize if they follow the prudent practice of managing risk from a global perspective.

Effective Internal Controls Environment: The board must ensure sound systems and controls are in place to manage investment risks.[17] Senior management is responsible for implementing an effective controls environment to manage risk in an institution's investment portfolio, as well as to ensure compliance with applicable laws and regulations. Diversification and providing for appropriate hold limits to ensure regulatory and board policy compliance are key controls. In addition, controls must be in place to ensure that only permissible investment activities take place.

Concentration in certain asset classes and securities highlighted control failures in many financial institutions during the height of the financial crisis. Careful investment selection and appropriate diversification are key ways to manage and control concentration risk. System institutions should effectively manage concentrations in any one investment issue or investment asset class, especially more complex, potentially illiquid, and higher-risk investments such as structured credit products. FCS institutions should limit their portfolio allocation in the following types of securities and, consistent with § 615.5140(c), must be able to demonstrate their marketability:

- Investments with historically volatile market values or cash flows;
- Structured investments with underlying collateral comprised of higher-risk assets or those likely to have limited liquidity in a stress environment;
- Investments that do not have readily determinable market values (that is, where price estimates rely on models instead of actual trades, such as investments classified as level 3 under Statement of Financial Accounting Standards 157/Accounting Standards Codification 820); and
- Investments that rely on a common risk mitigant, such as bond insurance.[18]

Each institution should review its risk profile on a routine basis and establish portfolio limits that are not only within the regulatory framework but are also within its risk tolerance limits and investment objectives. FCS institutions should limit their exposure to subordinated or complex structure investments that are otherwise eligible within a particular asset class and establish hold limits (or sub-portfolio limits) well below the regulatory maximums. For example, asset- and mortgage-backed securities often have multiple tranches of senior and subordinated securities that are all highly rated. FCS institutions should ensure the securities that they are purchasing meet their cash flow and risk and return objectives. Furthermore, while a class of investments may be eligible, buying entire tranches of a security generally does not provide System institutions with the necessary portfolio diversification and may also hinder future liquidity needs.

FCA expects FCS institutions to have sufficient controls to monitor investment trades to ensure their appropriateness and compliance with FCA regulations. Each institution must ensure it establishes the necessary controls to limit investment activity to permissible regulatory purposes. Specifically, FCS banks and associations are not authorized to engage in trading for speculative or primarily capital gains purposes. Realizing gains on sales before investments mature is not a regulatory violation as long as the profits are incidental to the permissible investment purposes outlined in § 615.5132.

Independent Audit Program: As discussed above, § 618.8430 requires each institution's board to adopt an internal control policy. System institutions should establish internal controls to ensure that an independent review over investment practices and controls is conducted. An institution's audit plan should include a risk assessment of the investment function by the internal audit department or by an outside vendor if the expertise in-house does not exist. The frequency and scope of review should be based on the complexity and size of the investment portfolio. For example, banks and associations with significant investment activities should typically ensure the investment function is audited at least annually. In addition, auditors should be rotated to obtain alternate views of investment operations. Outside audits of the portfolio should be conducted periodically as necessary to ensure an objective evaluation of practices and controls by qualified auditors.

Examples of areas that should be addressed by an institution's internal audit include, but are not limited to:

- Investment selection process;
- Process used by management to monitor investments;
- Incentives for traders and other treasury staff members/management;
- Risk management and measurement;
- Effectiveness of management oversight committees;
- Liquidity objectives;
- Portfolio composition;
- Reporting;
- Operational risk, including separation of duties, delegated authorities, and internal controls;
- Compliance with regulations, board policy, and procedures; and
- Implementation of FCA guidance (such as bookletters).

Due Diligence and Modeling Cash Flows and Assumptions: System institutions must conduct due diligence prior to purchasing a security. The degree of due diligence that an institution conducts must be commensurate with the complexity of the security. The need to evaluate and make a decision on a transaction quickly does not obviate the due diligence requirement. However, an institution may be able to conduct its analysis more efficiently by using a template or standardized form to document the risk and rewards of purchasing a particular security. Risk factors that must be considered in a due diligence analysis include, but are not limited to, price risk due to changing interest rates or prepayment speeds, and potential for credit risk deterioration and reduced liquidity and marketability under stressed conditions.

FCA expects that institutions thoroughly understand the risks and cash flow characteristics of their investments, particularly for products that have unusual, leveraged, or highly variable cash flows. System institutions must identify and measure risks prior to acquisition and periodically after purchase. It may be necessary to use third-party analyses that are independent of the seller or counterparty. In general, institutions should conduct and document due diligence analyses separately for each structured investment security. Modeling cash flows and assumptions at the time of purchase and periodically after purchase provides insight to the changing risks certain investments present.

Credit Risk Evaluation: Overreliance on NRSRO credit ratings in the credit evaluation of suitable investments was a significant problem for many financial institutions leading into the financial crisis. One reason that credit ratings may not necessarily reflect credit risk accurately is that the NRSROs and others may underestimate difficult-to-measure risk factors such as correlation. Correlation risk is the likelihood of an event that causes default of one credit increasing the likelihood of default in another credit.[19] In section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Reform Act), enacted on July 21, 2010, Congress recognized that credit ratings may not be the most appropriate means of determining creditworthiness.[20] Accordingly, institutions that continue to consider credit ratings as a factor in their pre-purchase and periodic investment credit evaluation should understand the processes and methodologies the NRSROs use as well as the limitations associated with these metrics.[21]

Moreover, we expect FCS institutions to reduce their reliance on credit ratings and to consider other factors in evaluating the risk present in credit products. A variety of robust pricing and valuation models include a credit assessment component. In particular, we encourage System institutions to use methodologies that incorporate the stress testing of cash flows, collateral default, and prepayment assumptions. Credit risk stress testing is a means to better understand the overall risk in the portfolio. Conducting such analysis would allow for better understanding of how certain investments fit in the overall risk framework of the institution.

Pricing and Valuation Practices: Section 615.5133(f) requires that before a System institution purchases a security, the institution must evaluate the security's credit quality and its price sensitivity to changes in market interest rates. The institution must also verify the value of a security that it plans to purchase, other than a new issue, with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction. Furthermore, the institution must determine the fair market value of each security in its portfolio and the fair market value of its entire investment portfolio at least monthly. The institution must also evaluate the credit quality and price sensitivity to change in market interest rates of all investments that it holds on an ongoing basis. Finally, before an institution sells a security, the institution must verify its value with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction.[22]

To satisfy these requirements, System institutions should have rigorous pricing and valuation practices in place to value investments. This includes using more than just dealer quotes but also using pricing services or other means of obtaining values. Achieving more than one price for each security provides for the ability to compare valuations.

Models may be used for securities that are more difficult to value. These models should have their assumptions calibrated regularly to ensure they are providing realistic valuations based on current market conditions. Model validation should be conducted regularly to ensure results are as accurate as possible. In addition, System institutions with securities that require models to assess their valuation should also ensure that these securities are marketable, which is a requirement for eligibility of all securities except money market instruments.[23]

Evaluation of Liquidity and Market Risk: Section 615.5132 of FCA regulations permits System banks to hold investments for liquidity reserve purposes. Investment policies must describe the liquidity characteristics of eligible investments that institutions will hold to meet ongoing liquidity needs, institutional objectives, and minimum regulatory liquidity requirements as described in §§ 615.5133 and 615.5134. As a result of the market turmoil, the quality and available liquidity of the investments of many System institutions have been adversely impacted, and the System, as well as FCA, recognize that liquidity, and liquidity policies, need to be strengthened. System institutions have already implemented action steps to improve liquidity, including holding larger quantities of higher quality liquid investments such as United States Treasury securities and other obligations that are fully guaranteed by the full faith and credit of the United States. We are currently reviewing our regulations and plan to propose enhancements in the future to help strengthen System liquidity.

A key component of liquidity, as well as a key component of investment eligibility under our regulations, is marketability.[24] Investments purchased for the purpose of meeting liquidity reserve objectives must be suitable for a liquidity portfolio, with broad market acceptance and limited risks. Even if investments are highly marketable when purchased, they may become less marketable or unmarketable in the future. In particular, even if private placements are eligible from a credit risk perspective at the time of purchase, experience has shown that they may not comply with FCA marketability requirements as discussed in § 615.5140(c). Liquidity for these investments may evaporate quickly in changing markets. Therefore, FCA expects FCS institutions to assess and test the marketability of their portfolio frequently, especially in areas where they have concentrations of asset classes. This assessment should include studies to determine the depth, breadth, and liquidity of the market for similar class and structure of securities.

Enterprise Risk Management: Some institutions have begun to move to a global, enterprise approach to assessing and managing risk. Enterprise risk management (ERM) identifies the broad spectrum of risks facing the institution, assesses the likelihood and magnitude of each risk along with risk correlations, and develops strategies for managing risks. ERM functions are a prudent business practice and provide a more disciplined approach to risk identification and management. Institutions that implement ERM functions should ensure risks from investment operations are considered and that those responsible for ERM have the tools and expertise to fully understand risks in investments and how it impacts the overall risk profile of the institution.

PILLAR 3 – RISK EVALUATION

An evaluation of risk is a crucial and ongoing component of investment asset management. Assessing current economic and financial conditions, emerging risks, and sector risk is critical to understanding the risk present in, and the impact various sectors have on, an institution's investments. Each System institution should continually monitor and assess risk so that the institution is aware of the external circumstances that can impact its investments and consequently its liquidity. This section also clarifies our expectations for stress testing mortgage-backed securities.

Assessment of Current Economic and Financial Conditions: Effective risk evaluation begins with an assessment of the current economic and financial conditions present in the marketplace. For instance, as we noted earlier, the financial crisis that began in 2007 did not deter institutions from purchasing higher risk mortgage-backed securities. At times, market conditions may change quickly and System institutions should have the ability, on an ongoing basis, to assess economic and financial conditions as part of their risk evaluation efforts and to adjust their portfolio strategies accordingly.

Identification of Emerging Risks: Emerging risks present additional challenges that System institutions should identify in their overall investment portfolio monitoring practices. Emerging risks, if identified early, can allow System institutions to exit certain segments of the portfolio or at least mitigate future risk of loss. Conditions may change very quickly and System institutions should have robust and dynamic monitoring systems and tools in place to ensure that emerging risks are identified and the effects of such risk on the institution are analyzed and understood. In doing so, System institutions can control and/or mitigate portfolio losses.

In evaluating emerging risks, institutions should ensure they consider:

- Correlation risk, changes in probability of loss, and loss given default;
- Ratings volatility risk (the potential for downgrade);
- Market liquidity and price discovery; and
- Credit spreads and volatility.[25]

In addition, System institutions with investments in private label structured credit products should take further steps to effectively monitor these types of investments. Specifically, institutions should track credit risk at the underlying collateral level, across securitization exposures, and within and across business lines. Also, they should obtain reliable measures of aggregate risk. This would include monitoring loan level risk limits where appropriate and restricting investment in securities backed by collateral with certain higher-risk characteristics. Higher risk characteristics would include higher loan-to-value ratios, low FICO scores, high delinquency rates, or securities that contain high levels of loans that were previously delinquent. Management should also consider other risks in such indirect investments, such as liquidity risk, especially in volatile markets.[26] Institutions lacking the expertise to fully understand the risks in these and other types of securities should not purchase them.

Sector Risk Evaluation: Being capable of understanding and evaluating the various sectors in which a System institution invests is critical to the institution's risk management and its overall management of its investment portfolio. Specific sectors include, but are not limited to, housing, automobiles, credit cards, and home equity type securities, as well as government guarantees. Having the appropriate tools and expertise to evaluate various sectors enables institutions to better understand the changing risks and complexities the investments pose. It is also critical that System institutions fully understand the impact that one sector may have on another.

Government-guaranteed investments are an important segment in the investment portfolio of many System institutions. As such, those institutions must have sufficient expertise to fully understand the nature and extent of the government guarantees supporting their investments. For example, government-guaranteed investments, such as Government National Mortgage Association-guaranteed mortgage-backed securities, are normally highly liquid, because the timely payment of both principal and interest is fully backed by the full faith and credit of the United States government. In contrast, some securities, even if they are labeled as government-guaranteed, are less liquid, because they are only partially guaranteed by the United States government. Consequently, as support for senior tranches erodes, institutions may begin to experience a loss and the securities may become less liquid. Management should perform the appropriate due diligence to understand the extent of the guarantees in its investment portfolio and the amount of risk involved in such securities. Institutions should ensure that they have sufficient expertise in place to fully understand the extent and nature of the guarantee on investments labeled as government-guaranteed.

Stress Testing: Under § 615.5141, mortgage securities are not eligible investments unless they pass a stress test as described in the regulation. An institution must perform stress tests to determine how interest rate changes will affect the cash flow and price of each mortgage security that it purchases and holds, except for adjustable rate securities that reprice at intervals of 12 months or less and are tied to an index. An institution must also use stress tests to gauge how interest rate fluctuations on mortgage securities affect its capital and earnings. An institution must perform stress testing at the time it purchases a mortgage security and quarterly thereafter.

An institution may choose to conduct either a specific three-pronged stress test prescribed in § 615.5141(a) or an alternative stress test as prescribed in § 615.5141(b). Whichever stress test an institution chooses to perform, it must rely on verifiable information to support all its assumptions, including prepayment and interest rate volatility assumptions. The institution must document the basis for all assumptions that it uses to evaluate the security and its underlying mortgages, and it must also document all subsequent changes in its assumptions. If at any time after purchase the mortgage security no longer complies with the stress testing requirements, the institution must divest of it in accordance with § 615.5143.[27]

Section 615.5141(b) requires that an alternative stress test must be able to measure the price sensitivity of mortgage instruments over different interest rate/yield curve scenarios. The methodology used to analyze mortgage securities must be appropriate for the complexity of the instrument's structure and cash flows. An institution must use the stress test to determine that the risk in the mortgage security is within the risk limits of its board's investment policies and does not expose the institution's capital or earnings to excessive risks. Our preamble adopting the alternative stress test emphasized that a comprehensive analysis may take into consideration a wide range of relevant factors.[28]

The FCA encourages each System institution's board to review its policies concerning the use of an alternative stress test. Board policies should identify which factors are relevant for management to consider when conducting an alternative stress test. These factors may change from time to time as conditions change. From the FCA's perspective, this flexibility is necessary because mortgage markets are often volatile. For this reason, board policies may direct management to consider factors such as credit quality, impact on the institution's market value of equity and asset-liability management, potential for the mortgage market to stabilize, and any other matter the board deems relevant. By considering appropriate factors, System institutions can refine their stress test to fit the desired risk profile of their organization.

In addition, an institution's board policy on investments may specify the factors that are appropriate to determine whether a security passes or fails an alternative stress test. If a security passes some individual tests within the overall alternative stress test but fails other individual tests, the institution's board policy may dictate that the security passes the overall test. An institution's board policy must document, in advance, what factors determine whether a security passes or fails an alternative stress test.

If a mortgage security no longer satisfies the stress testing requirements, it must be divested of in accordance with § 615.5143.[29] Section 615.5143 requires an institution to divest of an ineligible investment within six months unless FCA approves a longer divestiture period. It is not unusual for mortgage securities to fail, then pass, and then fail again stress tests in certain market environments. If a mortgage security fails a stress test but then passes a subsequent stress test before the 6-month regulatory divestiture period has elapsed, the divestiture period terminates. Only if the security fails every stress test within the divestiture period must it be divested of in accordance with § 615.5143, either by divestiture within the 6 months or by seeking FCA approval for a longer divestiture timeframe.

ASSOCIATION INVESTMENTS

Section 615.5142 of FCA regulations implements sections 2.2(10) and 2.12(18) of the Farm Credit Act, which require each funding bank to supervise and approve the investment activities of its affiliated associations. The funding bank may authorize associations to acquire eligible investments listed in § 615.5140, for the purposes of reducing interest rate risk and managing surplus short-term funds.

Funding banks are required to supervise and approve the investment activities of an association. However, as we stated in the preamble when adopting § 615.5142 in 1999:

> Bank oversight does not absolve an association's board and managers of their fiduciary duties to manage investments in a safe and sound manner. The fiduciary responsibilities of association boards of directors obligate them to develop appropriate investment management policies and practices to manage the credit, market, liquidity, and operation risk associated with investment activities. It is incumbent upon each association's investment managers to fully understand the risks of its investments and make independent and objective evaluations of investments prior to purchase.
>
> An association's investment policies should be appropriate for the size, risk characteristics, and complexity of the association's investment portfolio and should be based on an association's unique circumstances, risk tolerances, and objectives. Associations must comply with all the requirements in § 615.5133 if the level or type of their investments could expose their capital to material loss. However, an association's board does not need to develop an investment policy if it elects not to hold nonagricultural investments authorized under § 615.5140.[30]

This guidance is still valid today. Because the interest rate risk of most associations is managed by their respective funding banks, interest rate risk at the association level is minimized although not completely eliminated. Consequently, the use of investments for interest rate risk purposes should be limited. Some associations may, however, have surplus short-term funds that they wish to invest. System associations that choose to invest surplus short-term funds should consider the risks involved in purchasing various types of investments. In addition, the duration of the investments should match the availability and duration of the surplus short-term funds.

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[1]This bookletter does not apply to System service corporations, as FCA regulations do not specify any permissible purposes for which service corporations can make investments, or to the Federal Agricultural Mortgage Corporation (Farmer Mac), which is governed by its own investment management regulations in part 652, subpart A of FCA regulations.

[2]Section 615.5140(e) authorizes System institutions to hold other investments (not on the eligibility list) with FCA prior approval. This bookletter applies to all investments held for the purposes authorized by the regulations cited above. Investment management requirements and guidelines covering investments held for other purposes, such as mission-related investments, are imposed in connection with FCA's approval on a case-by-case-basis. They are generally similar to the guidance set forth in this bookletter but are tailored as necessary for the particular investment.

[3]FCA regulatory requirements discussed in this bookletter are found in § 615.5133 unless otherwise specified.

[4]*See* FCA's Fall 2010 Regulatory Performance Plan, available at www.fca.gov. The Regulatory Performance Plan may be found under Laws & Regulations (at the top), FCA Regulations (on the left), FCA Regulatory Performance Plan (on the left).

[5]Section 615.5133(b).

[6]Section 615.5133(c).

[7]*See* id.

[8]*See* id.

[9]*See* FCA Exam Manual EM-520.

[10]Section 615.5133(b).

[11]Section 615.5133(a).

[12]Id.

[13]Section 618.8440 requires each institution board annually to adopt an operational and strategic business plan.

[14]Section 615.5133(g).

[15]Id.

[16]Id.

[17]Section 618.8430 requires each institution's board to adopt an internal control policy that provides direction to the institution in establishing effective control over, and accountability for, operations, programs, and resources.

[18]The Federal Deposit Insurance Corporation (FDIC) issued similar guidance for institutions it supervises. *See* Financial Institution Letter (FIL)-20-2009, at 3-4 (April 30, 2009).

[19]FIL-20-2009, at 6.

[20]Section 939A of the Reform Act requires each Federal agency (with no exclusion for FCA) to modify its regulations to remove any reference to, or requirements of reliance on, credit ratings and to substitute in their place other appropriate standards of creditworthiness. We are considering the application of this requirement to FCA and the System's investments, and institutions should expect that we will address this issue in a future rulemaking.

[21]*See* FIL-20-2009, at 6.

[22]Section 615.5133(f).

[23]Section 615.5140(c).

[24]*See* § 615.5140(c).

[25]*See* FIL-20-2009, at 5-6.

[26]*See* id. at 4.

[27]*See* § 615.5141(c).

[28]64 FR 28893 (May 28, 1999).

[29]Section 615.5141(c).

[30]64 FR 28885-28886 (May 28, 1999).

Type: Bookletter
Section Number: BL-065
Section Title: Establishment and Implementation of a Shared-Asset Identifier
Old/Additional ID: [Old/Additional ID]

October 3, 2012

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Establishment and Implementation of a Shared-Asset Identifier

The Farm Credit Administration (FCA, we, our) Board strongly believes that in order to fully meet FCA's responsibility to ensure the safety and soundness of the Farm Credit System (System), we must have timely, complete and accurate information about shared assets. Shared assets include any loans or other assets with a common risk exposure between two or more System institutions through participation agreements, syndications, assignments, or other arrangements. The System must be able to identify and manage the risk exposure on shared assets at both the System and institution levels. It is also important that FCA have the capability to quickly identify and access information on such exposures. This bookletter describes FCA's expectations for each System institution and its board of directors to establish and implement an automated mechanism to consistently identify shared-asset exposures. Also, we believe it is important that the System demonstrate substantial progress towards establishing a shared-asset identifier and regularly update FCA on such progress.

Section 5.22A of the Farm Credit Act and Section 621.12(a) of FCA regulations require each System institution to prepare and file such reports of condition and performance as may be required by FCA. Further clarification is provided in Section 621.12(b), which states that these reports of condition and performance must be filed four times a year and may include such additional reports as may be necessary to ensure timely, complete, and accurate monitoring and evaluation of the affairs, condition, and performance of System institutions as determined by the Chief Examiner. In addition, Section 621.12(c) requires all reports of condition and performance to be submitted electronically in accordance with the instructions prescribed by FCA.

The FCA Board expects the board of directors and management of each System institution to support establishing and implementing an automated Systemwide mechanism to identify and report shared-asset exposure. This will allow FCA and the System to monitor this risk in a more timely and efficient manner. Once the System has established and implemented a shared-asset identifier, it will become a required data element field in the System's quarterly loan database submissions. For the longer term, the System's process should include the capability to aggregate and report loan exposures to individual borrowers or entities attributed for lending-limit purposes, and eventually to all affiliated borrowers. Also, FCA may request the System to consider additional criteria in the identification of shared-asset exposures as the System and FCA continue to assess data needs.

Because of the importance this effort will have on ensuring the safety and soundness of each System institution and the System as a whole, FCA expects by December 31, 2012, significant and timely progress by System institutions in developing and implementing an automated mechanism to identify, track, and report System shared assets. Therefore, within 30 days of each quarter end, beginning with the last quarter of 2012 and until the automated mechanism is fully implemented, the System will provide FCA with a written report on the progress towards establishing the shared-asset identifier.

In addition, we expect that:

1. The automated mechanism will
   a. report shared assets at the lowest loan record level captured in each institution's information systems and
   b. enable aggregation of loan information to the contractual credit facility and customer by institution and provide for the Systemwide aggregation of credit facilities and customers.
2. Each System institution and its board of directors will cooperate in implementing the automated mechanism.
3. Each institution will support its bank or data provider to ensure that the institution's shared assets are reported in a timely, complete, and accurate manner.
4. The shared-asset identifier for each shared asset will be reported as a data component of the System's quarterly loan database submissions to FCA in compliance with FCA's established submission schedule, format, and technological requirements.
5. System institutions will maintain internal controls to ensure accurate and complete shared-asset data.

Collaboration by the System will improve the mechanisms and disciplines necessary to effectively assess and report shared-asset risks in a timely, complete and accurate manner. In order to facilitate this collaborative effort, FCA reminds institutions that section 618.8320(b)(1) provides that "authorized representatives of . . . the bank concerned shall have free access to all information, records, and files" regarding borrowers. This provision permits System-authorized representatives to have access to all information as may be necessary to support the establishment and implementation of a shared-asset identifier, as well as for other purposes, such as systemic risk analysis.

To ensure a timely and accurate response to issues of risk identification and management, the availability of shared-asset identifier data is imperative. It is essential for FCA to have the capability to quickly access the detailed information on shared assets needed to evaluate in a timely and accurate manner the condition of each System institution and the System as a whole. Thus, the automated shared-asset identification mechanism described in this bookletter is integral to maintaining this capability.

If you have any questions about this bookletter, please contact Dave Stephens, Examination and Policy Director, Office of Examination, at (303) 696-9737 x2231 (stephensd@fca.gov), or Barry Mardock, Deputy Director, Office of Regulatory Policy, at (703) 883-4456 (mardockb@fca.gov).

Type: Bookletter
Section Number: BL-066
Section Title: Providing Credit to Farmers and Ranchers Operating in Local/Regional Food Systems
Old/Additional ID: [Old/Additional ID]

October 11, 2012

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Providing Credit to Farmers and Ranchers Operating in Local/Regional Food Systems

Summary
This Bookletter provides guidance on how Farm Credit System (FCS or System) associations can effectively meet the credit and related services needs of farmers who market their agricultural products through the local/regional food systems (local food farmers). The bookletter explains how System associations have authority to finance local food farmers and certain farm-related businesses under existing statutes and regulations and prior guidance issued by the Farm Credit Administration (FCA or Agency). It provides furthers guidance on how the regulations recently adopted by the FCA Board on System strategic business planning and senior officer compensation apply to financing local food farmers.

This bookletter provides specific guidance to the System on:

- Determining eligibility and scope of financing for local food farmers;
- Determining when a local food hub, aggregator, or support business qualifies for financing as a farm-related service business, processing or marketing operation, or similar entity;
- The application of creditworthiness and underwriting standards to local food farmers;
- The role of FCS banks in supporting association lending;
- Educational support for local food farmers; and
- Developing a strategic business plan for emerging agricultural markets.

Introduction
This bookletter applies to FCS associations operating under Titles I and II of the Farm Credit Act of 1971, as amended (Act). It provides guidance on statutory provisions and regulations and supplements previous guidance relevant to furnishing credit to farmers, ranchers and aquatic producers and harvesters (hereafter "farmers") and farm-related service businesses that operate within the local/regional food systems.

The FCS has a statutory mandate to serve **all** types of agriculture and agricultural producers. Section 1.1(a) of the Act states that one of the objectives of the statute is "improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them . . . and selected farm-related businesses necessary for efficient farm operations." Section 1.1(b) of the Act requires the System to "be responsive to the credit needs of *all* types of agricultural producers having a basis for credit." (emphasis added) Other provisions of the Act address eligibility and scope of financing, as well as providing of sound and constructive credit to YBS farmers.[1]

Agriculture continues to evolve as the farming population becomes increasingly diverse. The next generation of farmers will come through existing family farms, while others will enter agriculture as first generation farmers. Many first generation farmers are operating farms that market products within the local food systems. Many of these local food farmers are eligible to borrow from the FCS and are also creditworthy. Consistent with FCA regulation 618.8440(b)(8),[2] many System institutions will identify this market segment and develop lending programs to address credit and related financial services needs of local food farmers. The focus of this bookletter is to provide guidance on how FCS associations can effectively serve the emerging market segment of local food farmers using existing eligibility and creditworthiness guidelines.

A. Concepts

For the purpose of this guidance the following concepts apply:

- *Local/Regional Food Systems* are generally characterized by producers who practice sustainable production methods and whose short supply chain provides a connection between the producers and consumers. As discussed below, local food farmers meet the definition of bona fide farmers. There is no common definition of a Local/Regional Food System. However, the Food Energy and Conservation Act of 2008[3] defines a "locally or regionally produced agricultural food product" as one "that is raised, produced, or distributed within less than 400 miles from its origin, or within the State in which it is produced." According to a U.S. Department of Agriculture (USDA) study,[4] marketing channels, such as, direct-to-consumer (where farmers sell their products directly to consumers) and intermediated food sales (through regional distributors, grocery stores, restaurants, or other retailers) are considered local foods.
- A *food hub* is typically a "business or organization that actively manages the aggregation, distribution, and marketing of source-identified food products primarily from local and regional producers".[5] A food hub "strengthens the ability of farmers to satisfy wholesale, retail, and institutional demand"[6] in their local area or region. Food hubs include nonprofit (that develop out of community-based initiatives), privately held (limited liability companies or corporate structures), cooperative (producer or consumer owned), and local government owned entities.[7]
- An *aggregator* is a form of a food hub where food from more than one farmer is aggregated together and then marketed. Aggregators may or may not be owned by farmers. Farmers normally aggregate their agricultural products with those of other farmers. Non-farmers can either purchase the agricultural products from farmers or provide aggregator services on a commission basis when the farmers retain ownership of their agricultural products.
- A *community supported agriculture* (CSA) operation occurs when consumers provide upfront funds (buy a share) for a portion of the expected harvest from the farm, typically in the form of weekly harvest deliveries.

Due to their age, farming experience or size of farming operation, many local food farmers will qualify as YBS farmers under section 4.19 of the Act. As discussed in this bookletter, the implementing regulation at § 614.4165 and subsequent Agency guidance applies to these farmers.

B. Eligibility and Scope of Financing

The determination of whether to approve a loan to a local food farmer begins with a determination regarding the applicant's eligibility to borrow. Similarly, lending to farm-related service businesses also starts with a determination of eligibility. This determination must be made before creditworthiness is analyzed, which is discussed later in this bookletter.

1. Bona Fide Farmer

Sections 1.9(1) and 2.4(a)(1) of the Act state that "bona fide farmers, ranchers, and producers or harvesters of aquatic products" are eligible to borrow from Farm Credit banks and associations that operate under Titles I or II of the Act, respectively. The term "bona fide farmer or rancher" is defined in FCA regulation 613.3000(a)(1) as "a person owning agricultural land or engaged in the production of agricultural products . . . ."[8] To qualify as a bona fide farmer or rancher, it does not matter what type of agricultural product is produced, or the manner in which bona fide farmers market such products. For example, farmers or ranchers producing timber, vegetables, fruits, cattle, corn or soybeans all qualify as "bona fide" farmers. Similarly, farmers and ranchers are "bona fide" whether they market their agricultural products to grain elevators, marketers or processors, or directly to the consumer or through intermediated marketing channels, as is often the case for farmers who operate farms of smaller size and scale.

Examples of bona fide farmers operating in a local/regional food system include:

- The farmer who raises and processes cattle on rented land that is sold at local/regional farmers' markets as well as directly to restaurants while the farmer and spouse also work off the farm.
- The farmer who grows mixed vegetables on a rented 10 acre parcel and then markets the products through a combination of a CSA, local farmers' markets, as well as to local restaurants directly or through an aggregator.
- The farmer who grows vegetables on a one acre rented plot in a suburban or urban area and routinely sells the produce at local farmers' markets individually or through a cooperative of growers.

Bona Fide Farmer and Location of Agricultural Production

FCA regulations do not specify where agricultural production must occur for the person to qualify as a bona fide farmer. Therefore, if a person is engaged in producing an agricultural product for market in any location (rural, suburban, or urban) that person most likely meets the definition of a bona fide farmer and would be eligible for FCS financing.

Bona Fide Farmer and the Amount of Agricultural Income

FCA's regulatory definition of a bona fide farmer is not contingent on the amount of a farmer's agricultural income or the relationship between agricultural and non-agricultural income. Such limitations and expectations are not part of the general bona fide farmer eligibility determination. However, FCA does expect that a bona fide farmer-producer should routinely produce and market an agricultural product in a manner that demonstrates that agricultural production is the applicant's full-time or part-time vocation.

Scope of Financing

After an association determines that a farmer is an eligible borrower, it must then determine the extent of financing it can provide. FCS associations may extend credit for agricultural purposes to all eligible farmers, to the extent of their creditworthiness. The degree to which a farmer engages, or intends to engage, in an agricultural operation determines the amount of credit that a System association can extend for the borrower's other credit needs.[9] Most local food farmers seek credit primarily for their agricultural operations. However, the FCA recognizes that there are circumstances where farmers may also have off-farm businesses that provide income necessary to repay agricultural debt and provide for family needs. In a 2007 bookletter entitled "Providing Sound and Constructive Credit to YBS Farmers,"[10] the FCA provided guidance to FCS associations on treating a subset of part-time YBS farmers as full-time YBS farmers based on their (1) high degree of commitment to begin, grow, or remain in agricultural production, and (2) demonstrated intent to progress toward agricultural production as their primary business and vocation. System lenders may provide for all of the credit needs of farmers who meet these criteria so long as such financing assists them to progress toward farming as their primary business and vocation. Many local food farmers are YBS farmers and, therefore, may benefit from FCS associations' usage of the guidance provided in the 2007 bookletter. We encourage each System association to review the 2007 bookletter and, as appropriate, develop policies and procedures to implement programs to address the credit needs of YBS farmers, including those who are eligible and creditworthy local food farmers in the association's lending service area.

2. <u>Processing or Marketing</u>

Sections 1.11(a)(1) and 2.4(a)(1) of the Act authorize Farm Credit banks and associations to finance processing and marketing operations "directly related" to the operations of bona fide farmers, provided the farmers supply some portion of the throughput. Under § 613.3010, an eligible processing and marketing operation is "directly related" to the agricultural operation of the applicant if it is owned or controlled by bona fide farmers or is a direct extension or outgrowth of an eligible borrower's production operation.

Local food farmers often market their agricultural products in conjunction with other farmers or through food hubs or aggregators. Typically, farmers use these entities to help them deliver their products directly to the consumer,[11] or when their agricultural product lacks the needed volume and consistent availability for meeting the demands of the retail and food service customers.[12]

Food hubs and aggregators may qualify as processing or marketing operations if bona fide farmers at least partially own or control them and supply some portion of the throughput, in accordance with § 613.3010. Also, paragraph (a)(5) of this regulation authorizes financing for a legal entity that regularly processes or markets some portion of an eligible farmer's throughput and whose operations are a direct extension or outgrowth of the eligible farmer's operation.

Examples of processing or marketing operations in a local/regional food system context include:

- A local farmer aggregates his vegetables as well as the vegetables from surrounding farmers and markets the aggregated agricultural products through a CSA.
- Food hubs that are owned or controlled by farmers who supply some of the throughput or that are an outgrowth of an eligible farmer's operation.

3. <u>Farm-Related Service Businesses</u>

Sections 1.9(2), 1.11(c)(1), and 2.4(a)(3) of the Act authorize System banks and associations to provide credit to persons furnishing farm-related services to farmers that are directly related to their agricultural production. Such credit may include financing for necessary capital structures, equipment and initial working capital, including capital to lease with an option to purchase equipment or facilities needed for the provision of such services. An eligible farm-related business may provide a service to a bona fide farmer who retains ownership of the agricultural product during the time the service is being provided.

Under § 613.3020, a System association is able to finance all of the borrower's farm-related business activities if the farm-related business owner derives more than 50 percent of its income from furnishing farm-related services to agricultural producers. System financing is limited to only the farm-related service activities if the farm-related business owner derives 50 percent or less of its income from furnishing farm-related services directly to agricultural producers.

Examples of services provided by a farm-related service business in a local/regional food system context include:

- A company that through its web site provides the platform for bona fide farmers to advertise their agricultural products and for consumers (in this case mainly local restaurants) to purchase these products.
- A cold storage facility that provides storage services to bona fide farmers.
- A food hub where local and regional farmers come together to sell their agricultural products either directly to consumers or local intermediaries, such as local restaurants, schools, or small independent retailers.
- A livestock market that provides the facility where bona fide farmers sell their cattle.
- A peanut processor with no farmer ownership or control who weighs and sorts or shells and packages bona fide farmers' peanuts for further sale by the bona fide farmers.
- A beekeeper that provides bees for pollination of orchards and other fruits and vegetables.
- A mobile wine-bottling business that bottles the wine at the vineyard.
- Other examples of farm-related services include, but are not limited to the following:
    - Sheep shearing
    - Agricultural product hauling and delivery
    - Agricultural product storage or processing
    - Fertilizer and chemical application
    - Agricultural equipment repairs
    - Contract slaughterhouse facilities
    - Portable irrigation services
    - Agricultural product grading and cleaning
    - Large animal veterinarian services

4. Similar-Entity Financing

When a processor, marketer, or farm-related service business is not eligible for a System loan as discussed above, but its operations are functionally similar to those of an eligible borrower, it may qualify to receive financing as a similar entity. FCS banks and associations may participate with non-System lenders in credits to similar entities under the requirements of § 613.3300.

C. Creditworthiness/Underwriting Standards

Once the farmer or farm-related business is deemed eligible and scope of lending determined, the association must then analyze the farmer's creditworthiness. Creditworthiness, or having a basis for credit, is the analysis conducted by the association to assess whether it can make a loan to a farmer within its risk tolerance in a safe and sound manner. When analyzing creditworthiness, FCS associations use either their loan underwriting standards adopted under FCA regulation 614.4150 or their customized loan underwriting standards that have been established as a part of the association's YBS program under § 614.4165(c)(4). Some local food farmers who are also categorized as YBS farmers will meet an association's underwriting standards, but others, particularly new entrants into agriculture, may have difficulty meeting these underwriting standards due to their limited equity and collateral positions. However, they may be creditworthy as they typically generate sufficient cash flow from both their agricultural operation and, in many cases, their off-farm income to repay the debt. The FCS association's customized loan underwriting standards established under its YBS program will most likely be the best method to use to evaluate creditworthiness. These customized loan underwriting standards should account for the farmer's strengths as demonstrated by the farmer's business plan that details the production, managerial, financial, and marketing strengths that support the farmer's ability to generate sufficient repayment capacity. The underwriting program should also recognize the start-up nature of these operations where the applicant's capital position is limited and collateral will, in many instances, be the crop or equipment being financed.

As discussed above, some local food farmers sell their agricultural products at farmers' markets. The income of farmers who sell at farmers' markets is often enhanced by Federal assistance programs[13] that enable low-income consumers to purchase fresh fruits and vegetables directly from the producer. These programs allow consumers to use their electronic benefit transfer cards or vouchers at designated farmers' markets throughout the country. For farmers who sell at these farmers' markets, the programs effectively increase the pool of potential customers and as a result should increase the farmers' profitability and ultimately improve their creditworthiness.

D. Loan Quality

Loans to local food farmers should be consistent with the institution's loan underwriting standards. However, in many cases these loans will be to borrowers who may qualify under the association's YBS or other special programs. The determination of creditworthiness will typically be supported by the borrower's demonstrated production, managerial, financial, and marketing skills, and that the borrower has sufficient cash flow to service debt. Nevertheless, these borrowers may have limited capital and/or collateral positions and exhibit other potential weaknesses in creditworthiness. The FCA expects that the risk in these loans will lessen over time and will always be consistent with the institution's risk-bearing capacity.

When associations make these loans within their YBS programs, the FCA will not automatically criticize them because of credit quality. However, the FCA will review the loans and the YBS program to ensure that the YBS program policies and procedures and risk factors in individual loans do not adversely affect the institution's safety and soundness. A strong YBS program includes: (1) policies and procedures to market and lend to local food farmers; (2) designated capital committed specifically to support the loans made under the YBS loan program; (3) the use of customized loan underwriting standards, loan guarantee programs, fee waiver programs, and other credit enhancement programs; and (4) appropriate internal controls to assess the effectiveness of, and compliance with, the policies and procedures for the program. The loans to new local food farmers will typically be smaller credits that are in line with the credit needs of start-up or small farm operations. As such, this segment of an association's portfolio of loans should not have a material impact on the overall credit characteristics or risk bearing capacity of the association.

E. Role of Funding Banks

Section 4.19(a) of the Act requires each funding bank to adopt policies for YBS lending for its affiliated associations. The FCA expects that bank policies and the funding of its affiliated associations should be consistent with the guidance in this bookletter.

F. Educational Support

As part of their YBS program, many associations provide training services to YBS farmers. Training programs provided directly by FCS associations and other sources (e.g., extension services, community colleges, etc.) augment the credit provided to these farmers and provide an essential service to the agricultural community. Training in management, business planning, and finance are the principal types of educational support that the FCS and other parties offer to YBS farmers. In addition, some associations provide mentoring in concert with the training and use either their own credit staff or an external party for this purpose. We view training and mentoring as critical steps in helping YBS farmers achieve success. System associations should continue managing their YBS farmer lending relationships with these types of support. As you reach out to local food farmers and other new generation farmers, associations should also consider extending these training and mentoring programs to these segments of agriculture.

G. Developing a Strategic Business Plan for Emerging Agricultural Markets

A successful program to lend to eligible and creditworthy local food farmers begins with a commitment by the association's board of directors to lend to these farmers. This commitment is communicated through the association's business plan and YBS program (as required by FCA regulations 618.8440(b)(8) and 614.4165(c)(2)), which should include specific lending goals and a discussion of these lending programs. As part of its outreach efforts, the association should ensure that its staff is properly trained to recognize and effectively serve the current and future needs of these farmers. At the same time, the association's board and management should ensure that staff compensation and incentive programs support both the association's commitment to its YBS program and its outreach efforts to new and emerging agricultural markets (as required by pending FCA regulation 620.31(b)).[14]

If you have questions on this guidance, please contact Mark Johansen, Special Advisor to the FCA Board on YBS and Local Food Systems and Senior Policy Analyst, Office of Regulatory Policy at (703) 883-4064 or JohansenM@fca.gov.

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[1]Farm Credit Act of 1971, as amended, § 4.19, 12 U.S.C. § 2207.

[2]77 FR 25577, May 1, 2012.

[3]P.L. 110-246, 122 Stat. 1651, 1929 (June 18. 2008)

[4]Direct and Intermediated Marketing of Local Foods in the United States, USDA's Economic Resources Report Number 128 by Sarah A. Low and Stephen Vogel, November 2011.

[5]Regional Food Hub Resource Guide, USDA's Agricultural Marketing Services, page 4, April 2012.

[6]Ibid.

[7]Ibid., page 7.

[8]The person must be "a legal entity or an individual who is a citizen of the United States or a foreign national who has been lawfully admitted into the United States either for permanent residency pursuant to 8 U.S.C. 1101(a)(20) or on a visa pursuant to a provision in 8 U.S.C. 1101(a)(15) that authorizes such individual to own property or operate or manage a business or a legal entity." 12 CFR § 613.3000(a)(3).

[9]Lending Programs for Farmers' Other Credit Needs, FCA Examination Bulletin, October 2006.

[10]Providing Sound and Constructive Credit to Young, Beginning, and Small Farmers, Ranchers, and Producers or Harvesters of Aquatic Products, FCA Revised Bookletter 040, August 10, 2007.

[11]Direct-to-consumer outlets typically include farmers' markets, roadside stands, farm stores, and CSA.

[12]Retail and food service customers typically include groceries, restaurants, local businesses, and regional distributors.

[13]These federal programs include the Supplemental Nutrition Assistance Program (SNAP—formerly the Food Stamp Program), Women, Infants and Children's Program (WIC), Farmers' Market Program, WIC Cash Value Voucher, and Senior Farmers' Market Nutrition Program.

[14]Compensation Committees, 77 FR 60582, October 3, 2012 (effective date pending).

Type: Bookletter
Section Number: BL-067
Section Title: Lending to Similar Entities
Old/Additional ID: [Old/Additional ID]

March 10, 2016

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Kenneth Spearman, Board Chairman and
Chief Executive Officer

Subject: Lending to Similar Entities

In this Bookletter, we, the Farm Credit Administration (FCA), provide guidance to Farm Credit System (FCS or System) institutions that purchase participations[1] in loans originated by non-System lenders to qualified similar entity borrowers. We describe the policy, procedures, and internal controls that System institutions need if they participate in similar entity lending. These safeguards can help System institutions ensure compliance with sections 3.1(11)(B) and 4.18A of the Farm Credit Act of 1971, as amended (Act) and FCA regulation 12 CFR § 613.3300.[2]

Similar Entity Authority

Sections 3.1(11)(B) and 4.18A of the Act define a "similar entity" as a person or entity that is not eligible for a loan from a System bank or association, but has operations "functionally similar" to the operations of an eligible borrower under the applicable provisions of title I, II, or III of the Act, respectively. The qualified similar entity must derive a majority of its income from, or have a majority of its assets invested in, the conduct of activities that are "functionally similar" to the activities conducted by an eligible borrower.[3] Additionally, the Act and § 613.3300(c) of FCA's regulations set forth the following limits on similar entity transactions:

- *Exposure Limit:* The participation interest in the same loan held by one or more FCS institutions must not, at any time, equal or exceed 50 percent of the principal amount of the loan.
- *Obligor Limit*: The aggregate dollar volume of all similar entity participations that involve a single credit risk must not exceed 10 percent of an institution's total capital; or 25 percent of total capital for a Farm Credit Bank[4] or association as long as shareholders approve the higher limit.

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[1] According to section 3.1(11)(B)(iii) of the Act and 12 CFR § 613.3300(a)(1), "the terms 'participate' or 'participation' refers to multi-lender transactions, including syndications, assignments, loan participations, sub-participations, or other forms of the purchase, sale, or transfer of interests in loans, or other extensions of credit, or other technical and financial assistance."

[2] For the purposes of this guidance, a qualified similar entity borrower is a person or entity who is ineligible for a System loan, but has operations that are functionally similar to those of an eligible borrower and, therefore, may obtain FCS credit under the applicable similar entity provisions of the Act. The term "qualified" is used instead of "eligible" to provide a clear distinction between similar entities and eligible borrowers

[3] System banks and associations cannot use their similar entity authority to participate in rural home loans of the type authorized under section 1.11(b) or 2.4(a)(2) of the Act and under § 613.3030 of FCA's regulations.

[4] A Farm Credit bank operating under title III of the Act does not have authority to increase its obligor limit above 10 percent of its total capital.

- *Portfolio Limit*: The aggregate dollar volume of similar entity participations held by the institution must not exceed 15 percent of its total assets.

Purpose of Similar Entity Authority

Congress established the similar entity authority to provide System institutions and non-System lenders with a tool to manage risk. By lending to similar entities, System institutions can reduce geographic, industry, and individual borrower concentrations in their portfolios, and improve the results of their operations. The limits placed on System banks and associations reinforce that this authority must be used prudently and thoughtfully. Similar entity authority should not diminish in any way the System's primary mission as a lender to farmers, ranchers, their cooperatives, and other eligible borrowers in rural America.

Determination and Criteria

The determination of whether a prospective borrower qualifies as a similar entity is based on the activities of eligible borrowers. FCA expects the principal activities of the similar entity to align with those of an eligible borrower. System institutions should not focus on incidental activities of eligible borrowers when they assess whether a prospective borrower is a qualified similar entity.

Expectations: Policy, Procedures and Internal Controls

Similar entity authority subjects the System to significant scrutiny from Congress, FCA, and the public because it permits the System to participate in loans to ineligible borrowers. For this reason, FCA expects System institutions to have robust due diligence practices in place before participating in similar entity loans. All System institutions that participate, or that plan to participate, in similar entity loans should have policy, procedures, and internal controls that appropriately identify, evaluate, and mitigate various risks associated with this authority.

Policy and Procedures – Establish a board policy and implement procedures that provide adequate guidance to staff pertaining to similar entity lending. Such policy and procedures would include the following:

1. **The institution's risk management and diversification objectives**. These objectives include the following:
   - How the institution will use this authority to mitigate risk in the loan portfolio based on geography, industry, and individual borrower concentrations
   - Direction and risk parameters that reflect the board and management's appetite for all types of risk (i.e., credit, market, strategic, compliance, and reputation)
   - A description of the industries or borrowers that the board would want to avoid, as appropriate

2. **Criteria for assessing whether a borrower qualifies as a similar entity**. This process should ensure that the institution performs the following:
   - Adequately assess whether the prospective borrower qualifies as a similar entity
   - Determine that the prospective borrower's operations are principally involved in functionally similar activities
   - Comply with the limitations set forth in § 613.3300(c)

3. **Requirements that provide clear direction for analyzing a transaction**. The credit analysis should do the following:
   - Show that the entity requesting the loan, (not the parent or subsidiary of the entity) is functionally similar

- Describe the comparable directly eligible activities that the similar entity determination is based on, and the percentage of income and/or assets that the entity devotes to the similar activities
- Complete a more robust analysis and documentation for those situations in which a similar entity becomes less focused on functionally-similar activities (In some cases, a System institution may need to obtain a legal opinion or consult with FCA.)
- Describe the potential reputational risks that might result from the loan

4. **Periodic board reporting on similar entity loans**. Reports should be commensurate with the institution's level of activity and potential risk. FCA expects the reports to include the following:
   - Credit quality statistics
   - Industry and large loan concentrations
   - Compliance with risk parameters
   - Compliance with the portfolio and obligor limits
   - An assessment of the risk diversification benefits resulting from participating in similar entity loans

Internal Controls – Establish adequate internal controls to identify, manage, monitor, and reduce risks and ensure compliance with policies, procedures, and applicable regulations. Such internal controls would include the following:

1. **A process to ensure FCS institution and System-wide ongoing compliance with the exposure limit in § 613.3300(c)(2)**.

2. **Consideration of whether the obligor limits in § 613.3300(c)(1) and the portfolio limits in § 613.3300(c)(3) are appropriate**. If not, more restrictive limits should be established.

3. **A loan approval process, including delegations of authority**. The process should consider the nature of risk (including reputation risk) in these transactions.

4. **Internal audit and review coverage of similar entity loan activity**. This would include a review identifying all types of risk. It would also include a review to ensure compliance with FCA regulations and the institution's policies and procedures. FCA expects internal controls to require System institutions to report the results of reviews and corrective actions to their Audit Committees.

System institutions that have policy, procedures, and internal controls for similar entity lending should review and, if needed, revise them based on this guidance. Institutions planning to participate in similar entity lending that have not yet developed a similar entity policy, procedures and internal controls should use this guidance in developing them. Within 120 days of the date of this Bookletter, each System institution that engages or plans to engage in similar entity lending should submit its policy and procedures, as well as a description of its internal controls, to its examiner-in-charge. System institutions should also evaluate their compliance with previously issued guidance on reporting requirements.[5]

FCA will continue to study and assess other issues and risks associated with System lending to similar entities. We may issue further guidance about similar entities that we deem necessary or appropriate.

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[5] In October 2006, FCA sent all System institutions two documents: Frequently Asked Questions Similar Entity Reporting and a flowchart.

If you have questions on this guidance, please contact Jeremy R. Edelstein, Senior Policy Analyst, Office of Regulatory Policy at (703) 883-4497 or EdelsteinJ@fca.gov, Richard Katz, Senior Counsel, Office of General Counsel at (703) 883-4085, or KatzR@fca.gov, or Donald Sullivan, Senior Portfolio Manager, Office of Examination at (703) 883-4273, or SullivanD@fca.gov.

Type: Bookletter
Section Number: BL-068
Section Title: Tier 1/Tier 2 Capital Framework Guidance
Old/Additional ID: [Old/Additional ID]

December 22, 2016

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Dallas P. Tonsager, Chairman and
Chief Executive Officer

Subject: Tier 1/Tier 2 Capital Framework Guidance

The Farm Credit Administration (FCA or we) published the Tier 1/Tier 2 Capital Framework final rule (final rule) on July 28, 2016.[1] Subsequent to the publication, we identified a number of items, described below, that require additional guidance for implementation on the final rule's effective date of January 1, 2017. We intend to incorporate some of these items into the regulation in a future rulemaking project.

Contents:

1. First Bylaw Amendment or Board of Directors Resolution Date – § 615.5200

[1] 81 FR 49720, July 28, 2016. The rule adds a new part 628 to our regulations in Title 12 of the Code of Federal Regulations and amends existing parts 607, 611, 614, 615, 620, and 627.

The effective date of the final rule is January 1, 2017. The final rule does not specify the date by which the board of directors must adopt the initial annual board resolution or capitalization bylaw amendment. Therefore, FCA is giving System institutions until March 31, 2017, to adopt the bylaw amendment required under § 628.20(b)(xiv), (c)(xiv), and (d)(xi). If an institution's board of directors chooses to adopt a board resolution instead of a bylaw amendment, the board resolution must be in the capital plan submitted to the FCA by January 30, 2017.[2]

We note that the definition of "Unallocated Retained Earnings (URE) equivalents" in § 628.2 provides that institutions have until March 31, 2017, to designate as URE equivalents any nonqualified allocated equities that were allocated before January 1, 2017. However, we encourage institutions to make the designations before January 30 and include them in their capital plans.[3] Nonqualified allocated equities allocated after January 1, 2017, must be designated at the time of allocation to be considered URE equivalents.

We note further that a System institution is not required to amend its capitalization bylaws or adopt a board resolution that meets the requirements of the final rule. If a System institution does not have a board resolution in place or has not amended its bylaws to meet the regulation requirements, then no equities can count as common equity Tier 1 (CET1) or Tier 2 capital other than the statutory minimum borrower stock (2 percent of the loan or $1,000, whichever is less). As a result, CET1 capital will consist only of URE, the statutory minimum borrower stock requirement, and paid-in capital. If a System institution chooses to adopt a board resolution instead of amending its capitalization bylaws, the board resolution must be confirmed annually to include such equities under the new capital framework.

2. Capitalization Bylaw Requirement – § 615.5220(a)(6)

The final rule revises § 615.5220(a)(6) by requiring each System institution's capitalization bylaws to include a reference to the capital adequacy standards in new part 628. As amended, the regulation requires an institution's capitalization bylaws to include a statement that equities are retired at the sole discretion of the board, provided that minimum capital adequacy standards established in part 615 subpart H and part 628 are met.

FCA has determined that a System institution may delay adding the reference to part 628 to its capitalization bylaws until the next time the institution amends its capitalization bylaws. In addition, the FCA has learned that some institution capitalization bylaws currently do not cite part 615 of FCA regulations; instead, the bylaws contain only a general reference to maintaining compliance with FCA's capital adequacy standards. We have determined that such a general reference would satisfy the requirements of § 615.5220(a)(6) and would not require a bylaw amendment.[4]

3. Tier 1 Leverage Ratio Reporting – § 620.5(f)

The final rule adds § 620.5(f)(4)(iv) to require System institutions, in their annual reports for each fiscal year ending in 2017-2021, to report their Tier 1 leverage ratio for the years 2012-2016 in comparative columnar form.

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[2] This is consistent with the November 10, 2016, Office of Examination Informational Memorandum – Implementation of the Tier 1/Tier 2 Capital Framework.
[3] The capital plan must be included with the institution's business plan submitted to FCA "[n]o later than 30 days after the commencement of each calendar year." See § 618.8440.
[4] For example, an institution's capitalization bylaws may state that the institution must remain in compliance with the minimum capital adequacy standards established by FCA.

System institutions did not have a Tier 1 leverage ratio in the years 2012-2016. This requirement to report their leverage ratio was inadvertently placed in paragraph (f)(4) of § 620.5 and should instead be in paragraph (f)(3)(v) of § 620.5. Our intention was to require System associations to report their Tier 1 leverage ratio under § 620.5(f)(3).

System associations must report their Tier 1 leverage ratios in their annual reports to shareholders under § 620.5(f).

4. <u>Unallocated Retained Earnings (URE) and URE Equivalents Deductions – § 628.10</u>

Section 628.10(b)(4) establishes a minimum Tier 1 leverage ratio of 4 percent, of which at least 1.5 percent must be composed of URE and URE equivalents. Section 628.10(c)(4) states that Tier 1 capital deductions required under § 628.22(a) and (c) and § 628.23 must also be deducted when calculating the Tier 1 leverage ratio. However, the rule does not specify which deductions to make when calculating the minimum URE and URE equivalents requirement.

When calculating the URE and URE equivalents requirement for the leverage ratio, a System institution must deduct from the numerator an amount equal to all the deductions required under § 628.22(a).[5] All deductions made to the denominator when calculating the Tier 1 leverage ratio must be made to the denominator when calculating the URE and URE equivalents requirement.

When a System institution allocates equities to another System institution, the URE of the System institution that receives the allocated equites will normally increase. For this reason, we are requiring an institution to deduct from its URE and URE equivalents an amount equal to any allocated investments received from another System institution.

5. <u>Calculation of Permanent Capital – § 628.10(c)(5)</u>

Section 628.10(c)(5) provides that a System institution's permanent capital ratio is the ratio of the institution's permanent capital to its total risk-adjusted asset base, calculated in accordance with the regulations in part 615, subpart H of our capital regulations. Section 615.5201 provides that *risk-adjusted asset base* means "'standardized total risk-weighted assets' as defined in § 628.2 [of our regulations], adjusted in accordance with § 615.5207 and excluding the deduction in paragraph (2) of that definition for the amount of the System institution's allowance for loan losses that is not included in Tier 2 capital." The regulations in subpart H of part 615 that are relevant to calculating permanent capital include § 615.5206, Permanent Capital Ratio Computation, and § 615.5207, Capital Adjustments and Associated Reductions to Assets. We note that the deductions set forth in § 615.5207 for the permanent capital ratio denominator differ from the deductions for the new regulatory capital ratio denominators under the final rule. This results in a different denominator for the permanent capital ratio when compared to the new capital ratios under the final rule.

6. <u>Calculation of the Maximum Payout Ratio in the First Quarter of 2017 – § 628.11(a)</u>

If a System institution falls into either the capital conservation buffer (CCB) or leverage buffer, the maximum payout ratio and maximum leverage payout ratio under § 628.11(a)(2)(ii) and (a)(2)(v) must be calculated. These ratios determine the maximum amount the institution can pay out in the form of capital

[5] Section 628.10(c)(4) requires the amounts deducted under §§ 628.22(c) and 628.23 to be deducted from Tier 1 capital when calculating the Tier 1 leverage ratio. However, the deductions under §§ 628.22(c) and 628.23 would not be applied to the numerator when calculating the URE and URE equivalents requirement as they do not increase the URE of a System institution.

distributions and discretionary bonus payments. The maximum payout ratio and maximum leverage payout ratio are determined by the institution's CCB or leverage buffer, calculated as of the last day of the previous calendar quarter, set forth in Tables 1 and 2, respectively, to § 628.11. If an institution falls into either the CCB or leverage buffer in the first quarter of 2017, it would be unable to determine its maximum payout ratio and maximum leverage payout ratio as there was no CCB, leverage buffer, or CET1, Tier 1 or Total capital ratios calculated on December 31, 2016.

FCA has decided not to require System institutions to calculate their maximum payout ratio and maximum leverage payout ratio until after the quarter ending March 31, 2017. FCA's estimates of all System institutions' capital levels under the new framework show that all System institutions will be above the buffer levels on January 1, 2017. If an institution's regulatory capital levels fall in the first quarter of 2017 to levels that approach the minimum regulatory capital levels, we will use our supervisory and enforcement authorities to limit distributions as we deem appropriate.

7. Determination of the Minimum Holding Periods – § 628.20

The minimum holding period for purchased stock and allocated equities starts on the issuance date. The issuance date of allocated equities is defined as the date the institution segregates its "new" allocated equities (qualified and nonqualified) from its URE.[6] The issuance date could be the declaration date,[7] but there could be a short period between the declaration date and the segregation of the equities required for the issuance date. The payment date (the date on the patronage refund checks or the date on the written notices of allocation provided to the member-borrowers) typically would not be the issuance date since segregation of the equities would have already occurred. Segregating allocated equities must not be confused with the GAAP accrual of patronage refunds and allocation of equities that occur prior to the declaration date. The allocated equity segregation follows a board resolution (i.e., quarterly or annually) declaring the patronage refund in the form of cash or allocated equity.

8. Statutory Minimum Borrower Stock – § 628.20(b)

Section 628.20(b)(1)(xiv)(B) allows for the statutory minimum borrower stock requirement to count as CET1 capital notwithstanding the minimum 7-year holding period. The statutory minimum borrower stock requirement under section 4.3A of the Farm Credit Act of 1971, as amended (Act), is $1,000 or 2 percent of the loan amount, whichever is less.

FCA clarifies that the statutory minimum borrower stock includible in CET1 and the calculation of the regulatory capital ratios without a minimum holding period is the outstanding balance of the statutory minimum borrower stock.[8] If a loan is for $50,000 or more, the amount includible in CET1 capital without a minimum holding period is no more than $1,000 until such stock is retired. If a loan is for less than $50,000 at origination, the amount includible in CET1 capital is 2 percent of the originated loan amount until such stock is retired. If a revolving line of credit is originated for $50,000 or more and the amount of borrower stock is retired as the loan pays down, the amount of stock remaining on the calculation date, up to $1,000, is the amount includible in CET1 without a minimum holding period. If a revolving line of credit is originated for less than $50,000 and the amount of borrower stock is retired as

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[6] For example, a System institution board adopts a resolution to make a patronage distribution in cash and equity on December 5. On December 10, a general ledger entry is made that moves the dollar amounts from URE to an appropriate payable account and allocated equity. On January 5 of the following year, dollar amounts are assigned to each borrower. In this example, the issuance date would be December 10.
[7] The declaration date is the date a board passes a resolution declaring a patronage refund.
[8] Both the numerator and denominator of the regulatory capital ratios continue to be calculated using a 90-day (3-month) average daily balance.

the loan pays down, the amount of stock remaining on the calculation date, up to 2 percent of the originated loan amount, is the amount includible in CET1 without a minimum holding period.

FCA also clarifies that for any statutory borrower stock that exceeds $1,000 or 2 percent of the loan amount, whichever is less, the minimum holding periods apply if an institution plans to include the additional stock in Tier 1 or Tier 2 capital.

9. Common Equity Tier 1 Criteria – Claims on Residual Assets – § 628.20(b)(1)(ii)

Section 628.20(b)(1)(ii) states that one of the criteria of common cooperative equities includible in CET1 capital is that the holder of the equities is entitled to a claim on the residual assets of the institution only after all creditors, subordinated debt holders, and preferred stock claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding. For allocated equities whose holders are entitled to the residual assets of the institution and for all purchased equities, § 628.20(b)(1)(ii) applies to include those equities in CET1 if the holders would be paid only after all creditors, subordinated debt holders, and preferred stock claims have been satisfied. However, the capitalization bylaws of some System institutions may provide for the issuance of allocated equities whose holders do not receive the right to the residual assets of the institution in a liquidation or similar proceeding. If such equities meet all of the other criteria for inclusion in CET1, the equities are includible in CET1.[9]

10. Definition of Regulatory Financial Statements – § 628.20(b)(1)(xiii)

Section 628.20(b)(1)(xiii) provides that an instrument included in CET1 capital must be "reported on the System institution's regulatory financial statements separately from other capital instruments . . . ." The regulatory financial statements in question are the institution's call reports required by FCA's regulations at Part 621, subpart D, not other financial reports or statements issued by the institution.

11. Offset of Member Equities Against a Loan in Default – § 628.20(b)(1)(xiv) and (d)(1)(xi)

If a member defaults on a loan, the final rule does not permit an institution to offset equities (other than the amount of statutory minimum borrower stock outstanding) against the loan unless those equities have been outstanding for the minimum required holding period (5 or 7 years), or an exception specified in § 628.20(f)(6) applies.[10] As discussed above, the holding period would begin on the issuance date. For example, a borrower defaults on a loan and has allocated equities totaling $10,000. The institution's board resolution or bylaws state that those allocated equities will not be revolved for at least 7 years so that they can be included in CET1 capital. If the allocated equities have been outstanding for only 5 years, the institution would have to wait an additional 2 years before offsetting the equities against the loan. (We note that this restriction on offsets applies only to equities (other than the statutory minimum borrower stock) that the institution plans to include in Tier 1 or Tier 2 capital.) As discussed in the preamble to the final rule, FCA does not anticipate approving early redemptions and revolvements routinely.[11]

12. Tier 2 Capital Instruments – § 628.20(d)(1)(i)

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[9] This criterion was intended to start with "if," which would result in the same treatment as described above under this item.

[10] For example, equities that an institution is required to cancel under § 615.5290 in connection with a restructuring under part 617 may be offset against a loan in default.

[11] 81 FR 49728, July 28, 2016.

Section 628.20(d)(1)(i) includes criteria that an instrument must meet to be included in Tier 2 capital. This provision states that "the instrument is issued and paid-in, is a common cooperative equity, or is a member equity" purchased in connection with a loan.

FCA clarifies that Tier 2 capital instruments that are "issued and paid-in" include subordinated debt instruments, perpetual stock, and term preferred stock held by members or third parties that meet the Tier 2 capital criteria.

13. FCA Prior Approval (Safe Harbor) of Capital Distributions Made in 2017 – § 628.20(f)

The final rule requires institutions to obtain FCA prior approval before making any distributions of capital included in Tier 1 or Tier 2 capital.[12] There are three types of FCA prior approval: (1) the 30-day "deemed" prior approval that requires institutions to submit a request to FCA; (2) the "advance" prior approval that requires institutions to submit a request to FCA; and (3) the "safe harbor" prior approval that does not require institutions to submit a request to the FCA.

In general, under the "safe harbor" provision in paragraphs (f)(5) and (6) of § 628.20, cash dividends, cash patronage, and cash redemptions or revolvements of common cooperative equities (including the statutory minimum borrower stock) are deemed to have FCA prior approval provided: (1) the equities meet applicable minimum holding period requirements; (2) the dollar amount of CET1 capital after the cash payments is not less than CET1 capital on the same date in the previous calendar year; and (3) the institution complies with all regulatory capital requirements after the payments.

As stated above, the "safe harbor" provision may be utilized only when, after the payments, the dollar amount of CET1 capital does not decline compared to the same date in the previous year. Because institutions will not have a CET1 capital baseline from 2016 in order to determine whether they can make 2017 distributions in cash under the safe harbor, FCA is providing an alternate standard for use only in 2017.

During 2017, cash dividends on all equities, cash patronage, and cash redemptions and revolvements of common cooperative equities may be made under the safe harbor if the amount of GAAP total capital, excluding third-party capital and the effects of accumulated other comprehensive income, is not less than GAAP capital on the same date in 2016.[13]

14. Deceased Former Borrower Definition – § 628.20(f)(6)(ii)

Section 628.20(f)(6)(ii) refers to equities held by the estate of a deceased former borrower.

A "deceased former borrower" refers only to a deceased individual. This provision does not apply to the dissolution of a corporation or other business entity.

15. Allocated Investment Deductions from System Service Corporations – § 628.22(a)(6)

Section 628.22(a)(6) requires a System institution's allocated investment in another System institution to be deducted from CET1 capital.

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[12] We note that subordinated debt and term preferred stock may be redeemed on their maturity date without FCA approval, but such debt and stock are required to be phased out of Tier 2 capital as their maturity date approaches and cannot be included in Tier 2 capital in the last year before they mature.
[13] For purposes of this calculation, GAAP total capital includes all allocated equities regardless of their planned revolvement cycle.

FCA has determined that an investment allocated by a System service corporation to a System bank or association should also be deducted by the receiving bank or association under § 628.22(a)(6).

Although FCA is unaware of any service corporation that has made equity allocations to a System bank or association, allocations are permitted by some service corporations' bylaws. Because service corporations would include the equities they allocate in their permanent capital, such equities must be deducted from the CET1 capital of the receiving banks and associations in order to avoid the double counting of capital as described above under item 4.

16. Risk-Weighting of Funds on Deposit with Federal Reserve Banks, with Other System Institutions, and with Depository Institutions – §§ 628.32(a)(1)(i)(A), 628.32(c)(1), 628.32(a)(1)(i)(B), 628.32(d)(1), and 628.32(l)(1)

Section 628.32(a)(1)(i)(A) requires a System institution to assign a 0-percent risk-weight to an exposure to the U.S. Government, its central bank, or a U.S. Government agency. We confirm that this risk-weight applies to a deposit of a System institution's funds with a Federal Reserve Bank, since the Federal Reserve is the central bank of the United States.

Section 628.32(c)(1) requires a System institution to assign a 20-percent risk-weight to an exposure to a government-sponsored enterprise, other than an equity exposure or preferred stock. We confirm that this risk-weight applies, for example, to a deposit of an association's current funds with its district bank and to a deposit of a service corporation's current funds with its district or organizing bank or association, even if the funds are ultimately deposited elsewhere.[14]

Section 628.32(a)(1)(i)(B) requires a System institution to assign a 0-percent risk-weight to the portion of an exposure that is directly and unconditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency, including a deposit or other exposure or the portion of a deposit or other exposure that is insured or otherwise unconditionally guaranteed by the Federal Deposit Insurance Corporation (FDIC) or National Credit Union Administration. Section 628.32(d)(1) requires a System institution to assign a 20-percent risk-weight to exposures to U.S. depository institutions and credit unions that are not directly and unconditionally guaranteed. We confirm that the 20-percent risk-weight applies, for example, to a System institution's deposit with an FDIC-insured bank of funds in excess of the deposit insurance coverage of $250,000.

Section 628.32(l)(1) states, among other things, that an institution must assign a 0-percent risk-weight to cash held in accounts at a depository institution. This provision may create confusion about the proper risk-weight for deposits that exceed $250,000. In this Bookletter, we clarify that this provision should be read consistently with the provisions discussed in the previous paragraph. Specifically, a 0-percent risk-weight is assigned to deposits that are covered by deposit insurance and a 20-percent risk-weight is assigned to deposits that exceed the deposit insurance coverage.

17. Correction of Securitization Formulas – §§ 628.43(d) and 628.52(c)

[14] Section 1.5(11) of the Act authorizes a System bank to accept deposits of funds from associations in its district. Sections 2.2(10) and 2.12(18) of the Act authorize an association to deposit its current funds with its district bank. FCA regulation § 611.1135(a) authorizes a System bank or association, alone or with other System banks or associations, to organize a service corporation to perform any function or service that it is authorized to perform, with two exceptions not relevant to this issue.

The final rule includes four incorrect formulas – three under the simple supervisory formula approach (SSFA) under § 628.43(d) and one under the simple risk-weight approach (SRWA) under § 628.52(c). The following table shows the correct formulas that should be used when calculating the SSFA and the SRWA:

Calculation	Formula in the Final Rule	Correct Formula to be Used
SSFA - 628.43(d)	$K_A = (1 - W) \times K_G \times (0.5 \times W)$	$K_A = (1 - W) \times K_G + (0.5 \times W)$
SSFA - 628.43(d)	$a = \frac{1}{p \times K_A}$	$a = -\frac{1}{p \times K_A}$
SSFA - 628.43(d)	$K_{SSFA} = \frac{e^{au} - e^{al}}{a(u \times l)}$	$K_{SSFA} = \frac{e^{au} - e^{al}}{a(u - l)}$
SRWA - 628.52(c)	$X_t = A_t \times B_t$	$X_t = A_t - B_t$

18. Timing of the First Qualitative Disclosures – § 628.62(a)

Section 628.62(a) requires each System bank to provide timely public disclosures at the end of each calendar quarter. The preamble to the proposed rule states that System banks may disclose "qualitative disclosures that provide a general summary of a System bank's risk-management objectives and policies, reporting system, and definitions" annually at the end of the fourth calendar quarter, provided any significant changes are disclosed in the interim.[15]

FCA clarifies that System banks must provide their first qualitative disclosures at the end of the first calendar quarter after the rule becomes effective – that is, as of March 31, 2017. System banks must again provide qualitative disclosures at the end of the fourth calendar quarter – that is, as of December 31, 2017 – as long as they disclose any significant changes in the interim. After that time, System banks may provide qualitative disclosures annually, as long as they disclose any significant changes in the interim.

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If you have questions on this guidance, please contact:

- J.C. Floyd, Associate Director, Office of Regulatory Policy (ORP), at 703-883-4321 or FloydJ@FCA.gov;
- Jeremy R. Edelstein, Senior Policy Analyst, ORP, at 703-883-4497 or EdelsteinJ@FCA.gov;
- Rebecca S. Orlich, Senior Counsel, Office of General Counsel (OGC), at 703-883-4420 or OrlichR@FCA.gov; or
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[15] 79 FR 52858, September 4, 2014.

Type: Bookletter
Section Number: BL-069
Section Title: Strengthening Lending and Loan Servicing Controls
Old/Additional ID: [Old/Additional ID]

March 8, 2018

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Dallas P. Tonsager, Board Chairman and
Chief Executive Officer

Subject: Strengthening Lending and Loan Servicing Controls

The Farm Credit Administration issues this bookletter to provide further guidance on our expectation that each Farm Credit System (FCS or System) institution will continuously assess its lending and loan servicing controls to ensure controls remain effective and comply with FCA regulation 618.8430. This regulation outlines the minimum requirements that your institution's lending and loan servicing controls program must meet.[1]

A control program includes the policies and procedures the institution has established to manage risk and ensure the objectives of the board of directors are met. The controls help ensure that management carries out the board's directives to manage risks identified through the risk assessment process. Material lapses in lending and loan servicing controls at even one System entity could expose the entire System to financial loss and reputation risk.

Effective controls — both preventive and detective controls — help your institution's board of directors and management to meet the following objectives:

- Safeguard the institution's resources.
- Produce reliable financial reports.
- Ensure compliance with laws and regulations.
- Reduce the possibility of significant errors and irregularities.
- Detect errors in a timely manner if they do occur.

Because of the importance of control activities, board members must provide direction to help management create a culture that will help ensure that lending and loan servicing controls are effective.

[1] Please note that this bookletter does not apply to the Federal Agricultural Mortgage Corporation (Farmer Mac); FCA regulation 653.4 covers Farmer Mac.

Why we are issuing this bookletter

Regardless of your institution's complexity and size, you need strong lending and loan servicing controls to decrease your credit, compliance, and reputation risk, as well as your funding costs.

Because your institution is part of the System, inadequate controls in your institution may also have significant implications for other System institutions and even the whole System. Material lending and loan servicing weaknesses can impair the System's ability to issue timely combined financial statements and impact funding cost. We have worked closely with the Federal Farm Credit Banks Funding Corporation, System banks, and the System's external auditor to stress the importance of lending and loan servicing controls.

In this bookletter, we stress the importance of lending and loan servicing controls and provide guidance institutions can use to strengthen these controls. Our recent examinations have focused on the following:

- Board and management oversight and accountability to ensure a strong control culture within the institution
- Implementation of key lending and loan servicing controls, such as segregation of duties, approvals, verifications, reconciliations, and access controls
- Communication of information between employees and management within the institution, especially in the upward communication of problems
- Internal credit review programs, audit, and monitoring activities

How to establish effective lending and loan servicing controls

The following practices will help your institution guard against lending and loan servicing risks. Each institution has a unique and dynamic risk profile, so we urge you to continuously evaluate practices and enhance your controls where warranted. Your use of technology and business practices will also influence how you incorporate lending and loan servicing controls into your business processes. The practices listed below should be considered as part of your institution's risk assessment process, the scope of your credit reviews and audits, and your policies and procedures. Exceptions to policies and procedures should be justified and documented.

1. **Ensure segregation of duties.**

   Segregation of key duties is a fundamental element of an effective internal controls program. The basic premise is that no employee should be in a position both to perpetrate and conceal errors or fraud in the normal course of his or her duties. Different individuals should be assigned the responsibilities of originating loans, authorizing transactions, recording transactions, and maintaining custody of assets.

   Your institution should regularly evaluate its processes for segregating duties. Involving different people in key lending and loan servicing steps helps your institution detect errors and reduces the opportunities for individuals to perpetrate and conceal fraud. Your institution should continuously evaluate how it segregates the following duties:

   - Approving loans
   - Disbursing and receiving funds (including wire transfers)
   - Generating loans and managing relationships with borrowers
   - Monitoring credit
   - Processing loan charge-offs
   - Collecting funds
   - Posting to the ledger
   - Reconciling
   - Holding chattel and other collateral

   Within these functional areas, further segregations may be required. For example, the same individual who is responsible for general ledger functions should not be able to post information in the loan system.

   If you are unable to segregate these duties you will need to use mitigating controls. For example, if your staff is not large enough to allow for segregating all these duties, you may need to use other mitigating controls. This could include adopting a policy that requires officers and employees to be absent from their normal job duties with restricted access to systems for a specified period. These absences can be in the form of mandatory vacations, rotation of duties, or a combination of both. Required absences or rotation of duties, which are used by many financial institutions both inside and outside the FCS, are known to be effective in helping prevent and detect fraud.

2. **Ensure proper use of delegated lending authorities.**

   Delegating lending authorities grants an employee or committee authority to approve loan actions (for example, to set loan terms and conditions and to approve certain types of loans and loan servicing actions, such as the release of collateral). These delegations generally are based on factors such as the dollar amounts involved and the risk ratings of the loans. Employees and committees with more seniority and experience generally hold delegated lending authorities for complex, larger, or higher-risk loans.

Your institution's lending controls must include written policies, procedures, and processes for delegating lending authorities. These controls help ensure that no single individual has the sole authority to approve credit actions or manipulate data on large and complex loans, or other credits that present material risks to your institution's financial condition and reputation.

Properly functioning delegated lending authorities and lending committees will help ensure that loans are approved according to the board's risk appetite. They should also reduce your exposure to inappropriate practices or fraud that could lead to financial losses, litigation, and diminished reputation. To more effectively manage delegated lending authorities, you should consider taking the following measures:

- Develop written policies and procedures covering the use of delegated lending authorities. The policies and procedures for example should cover lending activities requiring delegated authority, disciplinary action for breach of policies and procedures, and a periodic review program.
- Monitor and report loan underwriting exceptions to the board and management to ensure that staff adheres to policies and procedures.
- Establish a formal and regular review of delegated lending authorities for staff at all levels.
- Require, when appropriate, a two-person approval process. For example, require the approval of both a credit analyst and a loan officer.
- Train all employees who hold delegated lending authorities on related policies and procedures.
- Ensure that policies and procedures require records to be kept of all decisions taken under delegated lending authorities.
- Keep meeting minutes and other materials to document approval processes for the review of board members, institution employees, FCA examiners, internal reviewers, and auditors.

3. **Evaluate processes for loan originations, disbursements, and payments.**

Your institution should have adequate lending and loan servicing controls to manage the complete lending cycle — from origination through maturity. These controls are needed to minimize the potential manipulation of loan proceeds or payments. To effectively manage this cycle, your institution should regularly re-evaluate the following:

- The segregation of the processes for loan closing, certification, payment, and funding
- The verification and authorization of disbursements or payments
- The verification of borrower requests for funds, including requests by email and phone (e.g., sight drafts)
- Wire authorizations (e.g., call-back or two-party verification systems)
- Processes for making corrections and adjustments to loan documents
- Written guidance for loan originations, disbursements, and payments

- Processes for evaluating the adequacy of controls over loan originations, disbursements, and payments
- The review, validation, and reconciliation of reports concerning loan originations, disbursements, and payments

4. **Ensure that pledged collateral exists and is appropriately valued.**

To avoid losses or under-collateralized loans, your institution's management must verify the existence and value of pledged collateral, and ensure the accuracy of information reported by borrowers and loan officers. An inspection report that does not match the information reported by the borrower (such as the borrowing base report or financial statement) may indicate borrower distress or potential fraud. Material deviations must be explained and incorporated into the analysis. The following practices will help protect your institution against under-collateralized loans:

- Establish clear risk-based expectations for the frequency, timing, and depth of chattel valuations, and real estate appraisals.
- Perform site visits to verify the existence and condition of pledged collateral in accordance with established frequency expectations.
- Ensure the independence of real estate appraisers, personal property and chattel evaluators, and the collateral evaluation function as required by FCA regulations.
- Use real estate appraisals, as well as personal property and chattel valuations to verify and reconcile collateral values with the credit analysis and financial statements used in the underwriting process.
- Periodically review work completed by internal and external real estate appraisers, as well as personal property and chattel evaluators, including loan officers.

5. **Use access controls to protect borrower information and institution data.**

Appropriate access controls can help prevent and detect fraud and ensure the integrity of personal and private information of borrowers and employees. Management must establish appropriate access to confidential information regardless whether the information is electronic or physical and regardless how the information is accessed (e.g., by laptop, by phone, or in person). Consider using the following practices to ensure your institution has appropriate access controls:

- Establish appropriate system access privileges for employees, contractors, and third-party service providers. Consider the principle of "least privilege," which gives an employee only the minimum set of access privileges needed to carry out his or her job responsibilities.
- Monitor access for excessive, unauthorized, or inappropriate activity.
- Conduct periodic independent reviews or approvals for individuals who perform multiple functions to minimize the potential for fraud, errors, and irregularities.

- Periodically verify that appropriate system access privileges were granted when employees were hired or promoted, and that system access privileges were removed when employees retired, were terminated, or had changes in their job duties.
- Review access logs and transactions to help protect confidential borrower information and support data integrity.
- Grant access to systems according to your institution’s written access control policies and procedures, and ensure that all employees follow these policies and procedures.

6. **Conduct credit reviews and audits.**

Institution boards and management are responsible for ensuring lending and loan servicing controls exist and operate effectively. This responsibility does not change whether the credit reviews and audits are outsourced or conducted in-house. Credit reviews and audits are critical for monitoring your controls’ compliance and effectiveness, and in identifying opportunities for improving these controls.

Credit reviews and audits must be sufficiently rigorous to identify and report the control weaknesses and to ensure compliance with policies, procedures, and regulations. Also, the board must hold management accountable for correcting material weaknesses in lending and loan servicing controls identified by internal and external parties. Consider using these practices when developing credit reviews and audits of lending and loan servicing:

- Create a multiyear plan that includes a risk assessment process to identify areas to be reviewed, to clearly define the scope of reviews, and to find opportunities to improve controls.
- Verify that the tools and processes your institution uses to track the status of corrective actions incorporate not only internal audit reports, but also external report findings, including FCA examination recommendations or required actions.
- Identify the individuals responsible for required actions and the deadlines by which the actions must be completed.
- Provide regular comprehensive progress reports to the board or the appropriate board committee.

7. **Use the “Three Lines of Defense” model to minimize gaps in lending and loan servicing controls.**

   Consider using the “Three Lines of Defense” model for assessing your institution’s lending and loan servicing controls. The three lines of defense are as follows:

   - Operational management
   - Risk management and compliance functions
   - The independent audit and credit review

   Each line is responsible for the risks inherent in the institution’s operations and is accountable for maintaining or testing to ensure effective lending and loan servicing controls to safeguard assets and resources.

8. **Establish clear roles and responsibilities to ensure accountability.**

   The board must establish clear expectations for the CEO and senior management to define roles and responsibilities for all employees. The board’s responsibilities in this area primarily involve oversight, authorization, and ethical leadership. Although board members do not design lending and loan servicing controls or prepare the written policies they adopt, they do help establish the culture around these internal controls. A board member can never delegate the responsibility to review and understand the lending and loan servicing controls policies and procedures the board approves.

   The board in turn relies upon senior management to establish effective lending and loan servicing controls. Senior management relies upon managers and department heads to recommend and implement procedures. Ultimately, everyone in the institution has a responsibility to ensure that the lending and loan servicing controls program is operating effectively and efficiently.

9. **Make lending and loan servicing controls part of your institution’s culture.**

   To make these controls part of your institution’s culture, your board must effectively communicate its expectations to management. The board must adopt policies that address the following areas:

   - Lending, servicing, and decision-making authorities
   - Segregation of duties
   - Human capital management (e.g., employee qualifications, ethical standards)
   - Operating and recording functions
   - Compliance with laws and regulations

   In turn, management establishes procedures and standards to implement the boards polices and effectively communicate the board’s expectations to staff. Finally, for these controls to become part of your institution’s culture, your board must ensure that all parties in the institution adhere to the established lending and loan servicing controls and safe and sound practices.

Conclusion

Your institution should continuously reassess and monitor the implementation of its lending and loan servicing controls. Of course, no matter how well designed and executed these controls may be, they cannot prevent all errors or acts of fraud. Limitations inherent in all control systems, such as collusion and management override, can reduce the effectiveness of lending and loan servicing controls. However, these controls can provide reasonable assurance that problems will not occur.

If you have questions about this bookletter, please feel free to contact any of the following FCA staff members:

- Ira Marshall, Senior Policy Analyst, Office of Regulatory Policy, at (703) 883-4379 or marshalli@fca.gov

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Type: Bookletter
Section Number: [Section Number]
Section Title: Revised Capital Treatment for Certain Water and Wastewater Exposures
Old/Additional ID: [Old/Additional ID]

November 8, 2018

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit Bank and Association

From: Dallas P. Tonsager
Chairman and Chief Executive Officer

Subject: Revised Capital Treatment for Certain Rural Water and Wastewater Facility Exposures

Over the past few years the Farm Credit Administration (FCA) has been studying and analyzing rural water and wastewater (RWW) infrastructure. RWW plays a critical role in agriculture and rural America, but its infrastructure is aging, and it can be difficult for rural communities to finance improvements. If managed appropriately, RWW exposures have a low risk profile. Under FCA regulations, RWW exposures, like all corporate exposures, are assigned a 100 percent risk-weight. However, our reservation of authority authorizes us, if we determine that the risk-weight for an exposure is not commensurate with the risks associated with the exposure, to require Farm Credit System (System) institutions to assign a different risk-weight to the exposure.[1] Based on our analysis of this industry, this Bookletter assigns a 50-percent or a 75-percent risk-weight to certain RWW exposures that satisfy specified criteria.

Water infrastructure is essential to rural industries such as farming, manufacturing, and mining, and to rural households, recreation and tourism, and other development.[2] The water infrastructure in many rural communities is aging and obsolete,[3] or nonexistent. Many small public water systems, often located in rural areas, have difficulties meeting the requirements of the Safe Drinking Water Act to provide safe drinking water to their customers.[4]

Many rural communities face difficulties in financing RWW infrastructure. In some cases, they do not have the number of users needed to share the cost of major infrastructure projects while

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[1] See § 628.1(d)(3).
[2] United State Department of Agriculture, *Report to the President of the United States from the Task Force on Agriculture and Rural Prosperity*, at 22-23. (October 2017).
[3] Government Accountability Office, *Rural Water Infrastructure: Federal Agencies Provide Funding but Could Increase Coordination to Help Communities*, GAO-15-450T (Feb. 27, 2015, new version posted on Nov. 6, 2015), at 1.
[4] Id. at 2.

maintaining affordable user rates. In addition, unlike larger urban communities, it can be difficult for rural communities to issue their own public bonds to pay for major improvements and, in many cases, they have limited access to financial markets, restricting their ability to issue bonds to raise capital.[5] Commercial banks do not appear to be a significant source of RWW infrastructure financing. Several Federal and state agencies provide grants, subsidized loans, and technical assistance to support RWW infrastructure, but the application process can be costly, time-consuming, and difficult.[6]

The System is another source of funding for RWW infrastructure, and a reduced risk-weight for exposures that satisfy specified safety and soundness criteria would provide more capacity for System institutions to provide this funding without taking on excessive risk. Our review of RWW exposures that the System finances confirms the overall financial strength and stability in this industry. The essential services provided by RWW facilities and the ability of many of these facilities to adjust rates as necessary helps support repayment capacity, thus reducing the likelihood of default.

Exposures Subject to Lower Capital Risk-Weight

Exposures to loans, leases, participation interests, and debt securities (other than asset- and mortgage-backed securities) of not-for-profit (corporate, municipal, and cooperative-owned) RWW facilities that operate outside cities or towns with populations of more than 20,000 residents and that satisfy specified criteria may be assigned a reduced risk-weight.[7]

Institutions may not assign the following exposures a reduced risk-weight using this Bookletter; instead, they must assign these exposures a risk-weight under Part 628:

- Exposures to similar entities.[8]
- Exposures during the initial construction or major renovation or expansion of a RWW facility such as a treatment plant, pumping station, or storage tank during which the facility is not fully operational, because of the additional risk that these exposures pose. When the initial construction or major renovation has been completed and the facility is fully operational, an institution may assign a reduced risk-weight. This exclusion does not apply to exposures during routine repair, upgrade, or maintenance projects that do not impede full operation of the facility.

Criteria for Receiving a Reduced Risk-Weight

FCA has established quantitative and qualitative criteria that an exposure to a RWW facility must meet to be assigned a reduced risk-weight.

[5] Id. at 7.
[6] Id at 1.
[7] Only exposures to such RWW facilities that are eligible for financing under and for which financing may be provided under section 3.7(f) of the Act and FCA regulation § 613.3100(d) may be assigned a reduced risk-weight. Among other requirements, these provisions limit financing to those facilities that operate in a rural area, which is defined as all territory of a State that is not within the outer boundary of any city or town having a population of more than 20,000 inhabitants based on the latest United States decennial census.
[8] As FCA Bookletter-067 explains, Congress established similar entity authority to provide System institutions and non-System lenders with a tool to manage risk. A similar entity is a person or entity that is not eligible for a loan from a System institution but has operations "functionally similar" to the operations of an eligible borrower. The Farm Credit Act of 1971, as amended (Act), and FCA regulations specify limits on similar entity transactions.

Quantitative Criteria for 50-Percent Risk-Weight

- The facility must demonstrate strong and stable repayment capacity to service all financial commitments (both principal and interest repayments) in a timely manner;
- The facility must exhibit below average leverage compared to industry peers; and
- The facility exposure must have a low risk of default.

The metrics associated with the quantitative criteria for a 50 percent risk-weight are as follows:

- Water and Sewer – Not-for-profit (corporate, municipal, and cooperative-owned) facilities that serve rural areas and communities of 20,000 or less.
  - Debt/EBITDA[9] $\leq$ 9X
  - DSC[10] $\geq$ 1.40X
  - Debt/Total Capital $\leq$ 50%

Quantitative Criteria for 75-Percent Risk-Weight

- The facility must demonstrate adequate and stable repayment capacity to service all financial commitments (both principal and interest repayments) in a timely manner;
- The facility must exhibit average leverage compared to industry peers; and
- The facility exposure must have a low risk of default.

The metrics associated with the quantitative criteria for a 75 percent risk-weight are as follows:

- Water and Sewer – Not-for-profit (corporate, municipal, and cooperative-owned) facilities that serve rural areas and communities of 20,000 or less.
  - Debt/EBITDA $\leq$ 11X
  - DSC $\geq$ 1.20X
  - Debt/Total Capital $\leq$ 60%

RWW exposures must meet all quantitative criteria. An exposure does not have to meet each specific metric; an institution may use a holistic approach and must document in its analysis compensating factors that allow the exposure to meet all quantitative criteria even if the metrics are not met. If an exposure satisfies the criteria, it may receive the reduced risk-weight. If an exposure does not meet the criteria, the exposure must be assigned a risk-weight according to Part 628 of FCA regulations.

[9] Debt to EBITDA is an operational profitability measure and a key ratio for risk-rating purposes. EBITDA stands for: Earnings before Interest, Taxes, Depreciation, and Amortization.
[10] Debt Service Coverage (DSC) is a ratio designed to measure the adequacy of cash flow to cover total debt service (both principal and interest).

Qualitative Criteria for 50 -and 75-Percent Risk-Weight

- Borrowers must evidence strong, experienced management.
- Industry conditions must be favorable with the borrower well positioned in the industry.
- Broader macro-economic conditions must be favorable for the borrower and the industry.

RWW exposures must meet all qualitative criteria. System institutions must document their compliance with all quantitative and qualitative criteria to receive the reduced risk-weight.[11]

System institutions may employ a probability of default (PD) risk rating system to determine whether an exposure may be assigned a reduced risk-weight. The rating system must incorporate our quantitative and qualitative criteria and institutions must perform due diligence to ensure the exposure satisfies these criteria. Under the System's current risk rating guidance, the criteria for a 50-percent risk-weight generally equate to a PD-5 and the criteria for a 75-percent risk-weight generally equate to a PD-7. Application of a rating system will be subject to ongoing examination of FCA.

Sunset Provision

FCA believes it is prudent from a risk prospective to review the RWW industry risk profile and reevaluate this reduced risk-weight after data on its implementation is available. Accordingly, this Bookletter includes a seven-year sunset provision. We believe this time frame will give System institutions some certainty as they provide credit for these exposures and will give the agency time to collect and review data needed to determine whether the reduced risk-weight remains appropriate. We will provide ample notice to institutions about any future actions we may take with respect to this capital treatment.

Reservation of Authority

If our examinations indicate that a RWW exposure imposes risks that are not commensurate with the risk-weight specified in this guidance, or if risks within the industry significantly change, FCA may require System institutions to change the assigned risk-weight for the exposure or class of exposures.

FCA maintains its reservation of authority to determine the appropriate risk-weight for any exposure that imposes risks not commensurate with the risk weight assigned. The capital treatment prescribed in this guidance is specific to the RWW exposures described in this guidance. This lower risk-weight does not apply to any other industries or exposures.

If you have questions on the guidance in this Bookletter, please contact Chris Wilson, Senior Financial Analyst, Office of Regulatory Policy at (703) 883-4204 (or by email at wilsonc@fca.gov), or Jennifer Cohn, Senior Counsel, Office of the General Counsel at (303) 696-0440 (or by email at cohnj@fca.gov).

[11] System institutions must make this determination as often as deterioration in financial trends are noted, and at least annually, based on the most recent audited or "review quality" financial statements.

Type: Bookletter
Section Number: BL-071
Section Title: Bookletter Interest Rate Risk Management Guidance for Farmer Mac

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March 14, 2019

To: Chairman, Board of Directors
Chief Executive Officer
Federal Agricultural Mortgage Corporation

From: Dallas P. Tonsager
Chairman and Chief Executive Officer

Subject: Interest Rate Risk Management Guidance for Farmer Mac

The purpose of this Bookletter is to provide guidance on interest rate risk management to the Federal Agricultural Mortgage Corporation (Farmer Mac). FCA Regulation § 652.30 requires the Farmer Mac Board of Directors (Board) to provide appropriate oversight and adopt an interest rate risk management policy. This regulation also establishes minimum requirements for the interest rate risk policy.

Interest rate risk is the risk that changes in interest rates could adversely affect an institution's financial condition and performance. Interest rate risk is generally measured as the sensitivity of an institution's cash flows, earnings, and economic value to changes in interest rates.

The Bookletter describes the policies, procedures, and internal controls that Farmer Mac should have in place to manage its exposure to interest rate risk. It also describes the necessary risk measurement, monitoring, and reporting systems that Farmer Mac should have in place for effective interest rate risk management oversight.

Risk Governance

The Board has the ultimate responsibility for the risks undertaken by Farmer Mac. To carry out its responsibilities with respect to the oversight of interest rate risk, the Board is charged with the approval of major strategies and policies on interest rate risk to provide reasonable assurance that management effectively identifies, measures, monitors, and controls Farmer Mac's exposure to interest rate risk. Therefore, the Board must be knowledgeable of the nature and level of interest rate risk taken. The Board should be adequately trained in interest rate risk concepts and be regularly informed by senior management about the level and trend of interest rate risk exposure. The Board or its designated committee of Board members is charged with overseeing the establishment, approval, implementation, and annual review of interest rate risk management strategies, policies, procedures, tolerances, and limits.

Policies and Procedures

Farmer Mac's Board must adopt an interest rate risk management policy that establishes appropriate risk exposure limits. Policies and procedures should include the integration of interest rate risk implications of new strategies, products, and businesses into the interest rate risk measurement and management processes. Policies and procedures should document and provide for controls over permissible hedging strategies and hedging instruments. Section 652.30 (c) establishes the minimum requirements of an interest rate risk management policy.

The Board is charged with oversight of senior management's appropriate execution of Board-approved strategies, policies, and procedures for managing interest rate risk within the designated lines of authority and responsibility. Among other things, senior management should:

- Maintain appropriate operating policies, procedures, and internal controls addressing interest rate risk management that include appropriate limits and controls over risk taking;
- Develop and implement comprehensive systems and standards for measuring interest rate risk, valuing positions, and assessing performance, including procedures for updating interest rate risk measurement scenarios and key underlying assumptions driving Farmer Mac's interest rate risk measurements;
- Incorporate interest rate risk into enterprise-wide risk management assessments to facilitate understanding of the interrelationships between interest rate risk and other risks, such as liquidity risk and the impact on earnings and capital.

Section 652.30 (d) outlines interest rate risk reporting requirements, including the requirement to identify deviations from the Board's interest rate risk policy. Senior management and the Board, or a committee thereof, should receive reports at least quarterly on Farmer Mac's interest rate risk profile. These reports should be sufficiently timely and detailed to allow senior management and the Board to:

- Evaluate the level and trend of interest rate risk being taken and compliance with established risk limits;
- Assess whether management's strategies remain consistent with the Board's expressed risk tolerance; and
- Fully understand the potential impacts of interest rate risk exposures on earnings and capital, including important assumptions underlying those measurements.

Interest Rate Risk Limits and Controls

We expect risk limits to be set in accordance with a well-articulated risk tolerance policy established by the Board. Examples include limits on net interest income (NII) sensitivity, market value of equity (MVE) sensitivity, duration gap, and the MVE to book value of equity (MVE/BVE) ratio in response to the selected scenarios. When determining risk exposure limits, senior management should consider the nature of the Farmer Mac's strategies and activities, its past performance, the level of earnings and capital available to absorb potential losses, and the Board's tolerance for risk.

The Board and senior management should consider, at a minimum, the following:

- Limits should not be set so far above actual risk exposures, or target levels of exposure, that they are meaningless or have no effect on risk-taking behavior. Target levels for risk exposure should generally be below the Board's risk limits.
- Changes in risk limits should be approved by the Board and documented in the Board minutes.
- Farmer Mac should have a formal system to monitor interest rate risk exposures against established limits. Senior management should ensure that appropriate and prompt follow-up action is taken when limit violations occur. Senior management should also maintain a record of all limit violations and report limit violations to the Board.

A strong internal control structure is vital to the interest rate risk management process. An effective system of controls includes the enforcement of official lines of authority and appropriate separation of duties. Additionally, internal review and audit of the risk limit structure, measurement processes, and compliance are all key elements of the control process.

Measurement and Monitoring

Robust interest rate risk measurement processes and systems are required to assess exposures relative to established risk tolerances. Such systems should be commensurate with the complexity of on- and off-balance sheet positions. The risk measurement system should enable Farmer Mac to identify and quantify the major sources of Farmer Mac's interest rate risk in an accurate and timely manner. Although Farmer Mac may rely on third-party interest rate risk models, interest rate risk managers should fully understand the underlying analytics, assumptions, and methodologies.

Scenario analysis is an integral component of interest rate risk management. Scenario analysis uses a model to predict a possible future outcome given an event or series of events, such as parallel and non-parallel changes in the yield curve and/or changes in borrower prepayment behavior. When conducting scenario analyses, management should evaluate a range of alternative future interest rate scenarios to assess interest rate risk exposure. The range should be sufficient to accurately identify basis risk, yield curve risk, and the risks of embedded options.

We expect management to perform simulation analyses to determine the effects on earnings (including core earnings), MVE, capital surplus[1], NII, and net effective spread under the selected interest rate scenarios. If the analysis shows that performance would be unacceptable under one or more scenarios, then management should consider modifying, rebalancing, or hedging the portfolio so that performance would be acceptable under the identified scenarios. Scenario analysis not only prompts management to consider the risks inherent in maintaining its current portfolio mix, but also allows management to assess strategic alternatives for improving performance. Examples of such scenarios include:

[1] Capital surplus refers to the difference between Core Capital and the regulatory minimum capital level established under Title VIII, Subtitle B of the Farm Credit Act of 1971, as amended.

- Instantaneous and significant changes in the level of interest rates (e.g., instantaneous parallel and nonparallel shocks);
- Substantial changes in the level of interest rates over time (e.g., prolonged rate shocks);
- Changes in the spreads between key market rates, including spreads relative to Farmer Mac funding costs (e.g., basis risk);
- Changes in the slope and the shape of the yield curve (e.g., yield curve risk);
- Changes in asset prepayment rates (e.g., contraction and extension risk); and
- Changes in interest rate volatility.

Farmer Mac's Board or designated Board committee should consider the results of scenario analyses when establishing and reviewing strategies, policies, and limits for managing and controlling interest rate risk. Accordingly, we expect reporting on scenarios to clearly identify any key assumptions that should be considered in interpreting results. The Board and senior management should periodically review the design of Farmer Mac's scenario analyses to ensure that they include the types of market conditions under which Farmer Mac's positions and strategies would be most vulnerable.

Risk managers should regularly re-evaluate the reasonableness of assumptions that underlie Farmer Mac's interest rate risk exposure estimates. Farmer Mac should document, monitor, and regularly update key model assumptions, such as prepayment speeds, interest rate spreads, and interest rate volatility. At a minimum, we expect the risk management process to include sensitivity testing of the key assumptions that exert the greatest impact on measurement results. When actual experience differs significantly from past assumptions and expectations, management should test a range of assumptions to appropriately reflect this uncertainty. When assumptions are adjusted from prior reporting periods, the changes and their effects on model outputs should be documented and clearly identified in policies and procedures.

Staffing

We expect senior management to provide for adequate personnel to measure and manage interest rate risk accurately and efficiently. Staff should possess adequate knowledge to perform the functions required with a high degree of competence. If Farmer Mac elects to use an interest rate risk model designed and supported by an external vendor, the vendor's services should include periodic staff training to promote full and productive use of the model. Key person dependencies should be identified and remediated in a timely manner. Management should provide for succession planning and identify possible options for replacement of key personnel.

Conclusion

Effective risk management requires an informed Board, capable management, and appropriate staffing. Additionally, an effective interest rate risk management framework requires a comprehensive risk management process that ensures the timely identification, measurement, monitoring, and control of risk. To carry out its responsibilities with respect to the oversight of interest rate risk, the Board must approve policies on interest rate risk that establish appropriate exposure limits based on Farmer Mac's risk-bearing capacity. We expect the Board to ensure that management develops and implement procedures and practices that translate the Board's goals, objectives, and risk tolerances into operating standards that are well understood by personnel involved in the risk management process and consistent with the Board's intent.

If you have questions about this Bookletter, please contact Joe Connor, Associate Director for Policy and Analysis, at (703) 883-4364 (connorj@fca.gov) or OSMO Director Laurie Rea at (703) 883-4232 (real@fca.gov).

Type: Bookletter
Section Number: BL-072
Section Title: Interest Rate Risk Management

January 9, 2020

To: Chair, Board of Directors
Chief Executive Officer
Chief Financial Officer
Each Farm Credit System Bank, Association, and Service Corporation

From: Glen R. Smith
Chairman and Chief Executive Officer

Subject: Interest Rate Risk Management

The Farm Credit Administration (FCA or we) is issuing this bookletter[1] to provide clarification and guidance to Farm Credit System (System) institutions on an effective interest rate risk (IRR) management framework. This bookletter does not constitute new guidance; rather, it communicates long-standing basic principles of sound IRR management. It applies to all System banks and associations, and to any service corporations or other System institutions holding interest rate sensitive assets or liabilities creating an exposure to IRR as defined herein.[2] The bookletter describes the IRR governance, policies and procedures, strategies, measurement processes, internal controls, and staffing that System institutions should have in place to manage IRR. It also clarifies expectations on how IRR programs at System institutions must be commensurate with their level of risk exposure as required by FCA regulation.[3]

IRR is defined as the risk that interest rate changes could adversely impact an institution's financial condition and performance. It is generally measured as the sensitivity of an institution's earnings and market value of equity (MVE - defined in attachment) to changes in interest rates.

This bookletter provides guidance on how to address IRR management requirements in FCA regulations. Section 615.5180 describes the requirements for IRR management at banks. Section 615.5182 requires associations and any other System institutions with IRR that could lead to significant declines in net income or market value of capital to comply with § 615.5180 and establish an IRR management program commensurate with the level of IRR exposure. In addition, § 615.5200(c)(7) requires that all System institutions consider the potential impacts of IRR in developing their capital adequacy plans.

FCA's IRR management expectations differ depending on the nature, complexity, and materiality of IRR. However, each institution should have processes sufficient to measure and manage its unique risks.

Key terms, as used in the context of this bookletter, are defined in the attachment.

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1 This bookletter replaces BL-012 Asset/Liability Management Practices, which is rescinded.

2 This bookletter does not apply to the Federal Agricultural Mortgage Corporation (Farmer Mac). The agency's expectations for IRR management at Farmer Mac were communicated in BL-071 – Interest Rate Risk Management Guidance for Farmer Mac, published on March 14, 2019.

3 Section 615.5180(a) requires the development, implementation, and effective oversight of an IRR management program tailored to the needs of the institution.

I. Governance and oversight

Institutions should have a sound governance framework for managing IRR. The board and senior management need to fully understand IRR sources and exposures, establish risk limits, and ensure IRR is consistent with the board's risk tolerance and the institution's risk-bearing capacity. This is accomplished by the following:

1. Establishing policies, procedures, and strategies for managing IRR
2. Allocating sufficient resources and assigning responsibilities for IRR management
3. Establishing processes for identifying, measuring, monitoring, controlling, and reporting IRR
4. Creating a system of internal controls, including audits and reviews, to ensure the integrity of the IRR measurement and management processes

Board members are not expected to be IRR experts, but they do need to understand it well enough to meet their fiduciary duties and responsibilities for oversight. At institutions with significant IRR (defined in the attachment), board members should obtain periodic training to understand IRR and meet their responsibilities.

We expect institutions with significant IRR to establish an asset/liability management committee (ALCO) to oversee IRR management. ALCO members should include senior managers and decision-makers from each of the institution's major functions that can directly or indirectly influence IRR exposure. The ALCO should actively monitor the structure of the balance sheet and establish strategies and controls that maintain IRR exposures within acceptable operating ranges as defined by the committee, and board limits. A committee charter should exist defining overall purpose, authorities, responsibilities, membership, quorum requirements, meeting frequency, and requirements to record meeting minutes and report committee activities to the board (or designated board committee).

II. Policies and procedures

As outlined in § 615.5180(c), the board and senior management must adopt policies and procedures that provide direction and limits on the nature and amount of IRR the institution may assume. We expect policies and procedures to be reevaluated and revised as necessary, commensurate with the institution's level and nature of IRR exposure.

IRR policies at all System institutions should address, at a minimum, the following:

1. Purposes and objectives of IRR management.
2. A description of the board's risk tolerance or risk appetite.
3. Requirements to measure and report to the board and management the potential impact of interest rate changes on earnings at least annually.

4. Quantitative limits on the impact of a ±200 basis point (bp) parallel, instantaneous and sustained interest rate shock on earnings.[4]
5. Requirements for IRR model management and validation, consistent with the institution's overall model risk management framework and sound business practices.[5]
6. Delegations of authority, including authorities retained by the board and approvals required for policy exceptions.
7. Reporting requirements.
8. Audit and review coverage.

Institutions with significant IRR should further expand board IRR policies to address the following:

9. An IRR governance framework, including the IRR management and decision-making process.
10. Requirements to identify and measure all significant sources of IRR.
11. Requirements to measure and report to the board and management the potential impact of interest rate changes on earnings at least quarterly.
12. Quantitative risk limits tailored to the institution's unique IRR exposures (if not addressed through the limits on parallel interest rate shock results). For example, if the institution is exposed to significant basis risk, policies should establish limits on this risk. If the institution purchases loans or investments at premium prices, the policy should establish limits on premium risk. The limits should ensure risks to earnings are maintained at an acceptable level.
13. Permissible hedging strategies and instruments, including related documentation and control requirements.

Board IRR policies at banks and block-funded associations (defined in the attachment) must address risk to MVE.[6] In addition, associations that pursue strategies that could threaten MVE and long-term earnings capacity under certain interest rate scenarios should also expand policies to address MVE risk.[7] More specifically, policies should address the following:

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[4] IRR policies may specify a substitute for the -200 bp shock during low interest rate environments. The board may consider using the FCA Call Report instructions which establish standardized substitutes to the -200 bp shock for call reporting purposes.

[5] Management and validation of the IRR model may be addressed in either the model risk management policy or the IRR policy.

[6] Section 615.5180(c)(2) requires policies and procedures to identify and analyze the causes of risks within the balance sheet, while § 615.5180(c)(3) requires the measurement of the potential effect of these risks on both projected earnings and market values (i.e., "MVE" as discussed in this bookletter).

[7] Associations that concentrate equity in funding the longest-term assets, or mismatch funds transfer pricing (FTP) and options in a manner that results in significant intermediate-term or long-term mismatches, are expected to measure and manage MVE risk. Full MVE simulation using sophisticated and complex models may not be required if sources of MVE risk are limited and clearly defined, and risk can be reliably measured and effectively managed using an alternative approach. Any alternative approaches to MVE risk measurement should be well documented and defensible, and exposures must still be subject to board limits.

14. Requirements to measure and report to the board and management the potential impact of interest rate changes on MVE at least quarterly.
15. Quantitative limits on the impact of a ±200 bp parallel, instantaneous and sustained interest rate shock on MVE.[8]

We expect risk limits established in policies to be set at levels that do not unduly threaten earnings or MVE. Periodic policy reviews should ensure risk limits remain consistent with the board's risk appetite as well as any changes in the institution's risk-bearing capacity. At institutions that measure MVE, the periodic reviews should also consider the MVE/Book Value of Equity ratio (MVE/BVE ratio) and adjust risk limits if necessary to prevent this ratio from declining to an unsatisfactory level. Limits established in relation to net interest income should not expose bottom-line net income to excessive risk.

Management's written operating procedures should translate the board's policies and risk tolerance into operating standards that are well understood by staff and are consistent with the board's intent. We expect procedures to be sufficiently detailed to communicate management's expectations, ensure consistency and continuity of processes, and provide the criteria for holding staff accountable. Procedures should address each key IRR measurement, management, and oversight function. At institutions with significant IRR, procedures should establish precautionary thresholds (or targeted operating ranges) for each major IRR source, including actions that will be taken if those thresholds are breached. Such thresholds are more conservative than board policy limits. In addition, procedures or other types of management directives should assign responsibilities for each key function.

III. IRR strategies

FCA expects institutions to develop strategies for managing and mitigating IRR sufficient to maintain risk at an acceptable level. Some degree of IRR is a normal part of a financial institution's operations, but excessive IRR can threaten financial condition and performance.

Strategies should be consistent with the nature and complexity of the institution's business model and balance sheet composition. For example, associations that have a policy, strategy, and practice of fully match-funding assets through the funding bank's funds transfer pricing program (FTP – defined in the attachment) may not need to identify any additional IRR strategies or risk-mitigating steps. Other institutions may need strategies for managing and controlling each significant source of IRR. Strategies should be tailored to the unique risks, range of business activities, operating environment, and challenges facing the institution. Considerations include the following:

1. Strategies should be effective at maintaining IRR exposures within the board's IRR limits and risk appetite. Excessive IRR exposure, or exposure that is volatile and varies significantly across measurement periods, generally indicates strategies are inadequate.
2. The risks/rewards of significant IRR strategies should be periodically analyzed, quantified, and reported to the ALCO and board. These analyses should identify how risk/reward has changed over time and in relation to a neutral position (i.e., fully

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[8] As discussed in footnote 4, IRR policies may specify a substitute for the -200 bp shock during low interest rate environments.

matched position) and other feasible strategy alternatives. The analyses should determine if strategies continue to accomplish intended objectives.

3. Strategies should consider and control risks to both earnings and MVE (reducing risk to earnings can increase risk to MVE, and vice versa), and be periodically reassessed as economic and interest rate conditions change.
4. The capacity to generate acceptable overall earnings should not be overly reliant on IRR positions and strategies that are vulnerable to changing market conditions.
5. Major changes in IRR strategies and new business initiatives that affect IRR should be proposed to and approved by the ALCO before implementation. Proposals should address the impact on IRR, ability to measure and manage IRR, processes used to control IRR, and cost of measuring and managing the additional risks.
6. Using derivative instruments could be an effective strategy for hedging or mitigating IRR. Hedging with derivatives is a potentially complex activity that can have unintended consequences, including increasing IRR or compounding losses if used incorrectly. Thus, institutions using derivatives must have the necessary knowledge and expertise in these instruments. In addition, the board and senior management should understand the derivative strategy, including potential risks and benefits.

IV. IRR measurement

System institutions must have processes to accurately measure IRR.[9] IRR measurements are significantly impacted by the data available and used for analysis, the model employed, modeling assumptions, and the types of interest rate scenarios considered. Accordingly, a sound IRR governance framework should address these factors. Factors key to measuring IRR include the following:

1. The IRR model used should be sufficient to measure the institution's unique risks as well as compliance with limits in policies and procedures. The type and sophistication of the model needed depends on the complexity and nature of the institution's risk profile. For example, an association that uses the bank's wholesale FTP rates to match-fund assets and position equity proportionally across the balance sheet might use a relatively noncomplex spreadsheet or financial forecasting application to measure risks. An institution with significant IRR may need a much more sophisticated and specialized model. Despite varying levels of sophistication and complexity, all institutions should have a model that captures relevant and appropriately detailed data, provides a reliable estimate of IRR exposure, and is capable of measuring risks from all sources of IRR significant to the institution.
2. We expect model risk associated with measuring IRR to be managed consistent with the institution's overall model risk management framework, which should adhere to sound business practice guidelines for model risk management, validation, and related internal controls.[10]

[9] Section 615.5180(a) requires risk management processes to effectively measure IRR exposures.

[10] Sound business practice guidelines may include broadly accepted industry standards promulgated by trade groups, professional organizations, or industry leaders with subject matter expertise in model risk management; previously issued and broadly adopted guidance from the other financial regulators; and applicable Systemwide guidance issued by FCA.

3. If measurement of the sensitivity of earnings to IRR assumes a dynamic balance sheet, then risk should also be measured assuming a static balance sheet to provide the board and senior management a complete understanding of IRR exposure. This is especially important if dynamic balance sheet assumptions include management's expected responses to interest rate changes or otherwise have the potential to mask IRR, or if changes in dynamic assumptions prevent an understanding of IRR trends.[11]
4. The types of interest rate scenarios used should be tailored to measure the institution's unique IRR sources. At minimum, FCA expects institutions to use parallel interest rate shock scenarios to measure IRR. Other types of scenarios should be added when needed. For example, institutions may also need to measure the impact of basis shocks, nonparallel interest rate shocks, lags in interest rate adjustments, and other scenarios depending on the institution's specific sources of IRR. At institutions with complex IRR exposures where it is difficult to identify all sources of IRR, a range of scenarios should be used to fully identify and measure all risks.
5. The severity of interest rate scenarios should be sufficient to measure the institution's IRR. The assumed changes in interest rates should be meaningful relative to the institution's IRR sources, logically defensible, and supportable. At a minimum, we expect parallel interest rate shocks measuring the potential impact of a ±200 bp change in rates. More severe shocks, such as ±400 bp, should be measured at institutions with significant IRR. Such severe shocks may capture unique risks like those caused by options in the balance sheet. Basis risk scenarios should include severe yet plausible shocks that exceed normal historical volatility. IRR measurements of extreme events should also be considered as they can provide important insights into balance sheet positions and risks.
6. At institutions with significant IRR, FCA expects management to maintain a formal process to periodically review, recalibrate, and approve changes to assumptions and any sub-models or functions used to derive assumptions (e.g., prepayment models). Testing the sensitivity of modeled results to key assumptions is an important part of this process. Sensitivity testing identifies the potential impacts if assumptions prove incorrect or diverge significantly from expectations and historical behavior. Testing the model's sensitivity to various assumptions heightens management's awareness of the potential risks and risk mitigation strategies that may be needed. This can also identify the assumptions that should receive the most attention in model validation.
7. The time horizon used in IRR measurement should be sufficient to capture significant IRR exposures to earnings. At a minimum, we expect IRR measurements assessing the impact of interest rate changes on earnings over the next 1-year period. However, such a short-term horizon will not capture the impact of any intermediate-term and long-term mismatches. Such exposures can arise from concentrating most equity to fund intermediate or longer-term assets, and mismatching the maturity, repricing, or option characteristics in intermediate or longer-term assets and liabilities. Institutions with significant IRR should supplement the 1-year measurement with projected exposures over longer time frames. In addition, to

[11] Static and dynamic balance sheet assumptions are defined in the attachment. Comparisons of static to dynamic measurements of earnings sensitivity may not be necessary if reporting to the board and senior management routinely includes analysis detailing the impacts of dynamic assumptions (and changes in assumptions) on IRR measures. Reporting should support that dynamic assumptions are not masking the level or trend in reported IRR.

understand how risk evolves, institutions should measure the sensitivity of earnings to IRR for each 12-month period over the measurement horizon (as opposed to cumulative impact).

V. Internal controls

FCA expects institutions to maintain strong internal controls over IRR management processes. A strong internal control structure is vital to IRR measurement and management. An effective system of controls includes the enforcement of official lines of authority and appropriate separation of duties. Additionally, audit and review are key elements of the control process.

If the institution has significant IRR, then those responsible for measuring IRR should be independent from those who take or manage risks. This includes those that develop IRR strategies as well as those who make or carry out decisions that directly affect the structure and types of assets, liabilities, and financial positions of the institution. The individuals responsible for taking or managing risks should not be in a position to influence IRR model assumptions and risk measurement results, assess compliance with policy, or report results of strategies to the board. If full separation of these duties is not practical, independent controls should exist that ensure IRR measurement and reporting are accurate and unbiased.

A qualified internal audit or outside independent party should review the adequacy of IRR measurement and management processes. The scope, depth, and frequency of audits and reviews should be commensurate with the complexity and materiality of IRR. Areas that should be considered in the scope of audit and review include the following:

1. IRR-related policies and procedures
2. Compliance with policies, procedures, and FCA regulations, and adherence to sound business practices
3. IRR strategies
4. IRR model, particularly controls over model reliability and accuracy, and consistency with model governance requirements in the institution’s model risk management framework
5. IRR measurements and interest rate scenarios, including an assessment of whether they adequately capture and measure all significant IRR sources
6. Internal controls, including delegated authorities, separation of duties, review and approval processes, management oversight committees, and staffing
7. Board and management reporting on IRR

VI. Staffing

Institutions should allocate sufficient staffing resources to IRR measurement and management, commensurate with the nature and complexity of IRR. Staff should have the necessary technical and IRR management skills to fulfill their assigned responsibilities and be provided with ongoing training to maintain those skills. An association that uses the funding bank's FTP processes to match fund the balance sheet may be able to eliminate complex exposures, but sufficient skills should still exist to accurately measure IRR and ensure risks are eliminated through match-funding. No institution should increase the complexity of IRR without ensuring it has the staffing resources and expertise necessary to effectively measure and manage the new risks. In addition, key person dependency risks should be identified and mitigated in a timely manner. Potential backup for key personnel should be identified through succession planning and cross-training.

VII. Additional guidance

The basic principles of sound IRR management discussed in this bookletter are largely consistent with those previously published by the other financial regulators.[12] System institutions with significant IRR would benefit from review of the 2010 Interagency Advisory on Interest Rate Risk Management, along with the subsequent 2012 issuance of Frequently Asked Questions (FAQs).

If you have questions about this bookletter, please contact any of the following FCA staff members:

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[12] For example, Federal Reserve Letters SR 10-1, January 11, 2010, and SR 12-2, January 13, 2012 describe basic principles of sound IRR management. The financial regulators that were involved with issuing this interagency guidance were the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Financial Institutions Examination Council State Liaison Committee. Federal Reserve Letter SR 11-7, April 4, 2011, describes sound principles of model risk management.

Attachment

These key terms are used in this bookletter to mean the following:

Funds transfer pricing (FTP): FTP refers to bank processes for determining wholesale rates charged on association direct loans. Under this process, System banks determine a distinct wholesale funding rate for each association loan to a retail customer. Associations are typically able to match-fund each individual asset (e.g., loans, investments, etc.) with a transfer rate that eliminates most IRR for the association. Associations that make full use of the benefits of this process maintain a generally match-funded balance sheet and can avoid the costs of implementing and maintaining sophisticated models and systems for managing IRR.[13]

Block-funded associations: Refers to associations that do not use the funding bank's FTP process. Instead, they order blocks of funding from the bank and manage their own asset/liability mix. Block-funding results in complex IRR akin to those at a funding bank, requiring sophisticated IRR measurement and management processes, and dedicated subject matter expertise.

Institutions with significant IRR: This term refers to those System institutions that need to adopt a more comprehensive IRR management framework that goes beyond baseline minimum requirements in order to comply with § 615.5180.[14] This term refers to banks and block-funded associations. It also refers generally to associations that significantly mismatch FTP rates or options or that position equity in a manner that could lead to significant declines in net income or MVE.[15] Such associations are subject to the requirements in § 615.5180 commensurate with the nature and complexity of their IRR exposures. These associations should establish policies, procedures, and processes sufficient to effectively measure and manage their unique sources of IRR. Any other System institutions (e.g., service corporations) with significant IRR must also comply with § 615.5180.

Market value of equity (MVE): MVE equals the net present value of forecasted cash flows for existing financial positions discounted using prevailing market interest rates and spreads, plus the book value of positions that do not have cash flows (e.g., cash, plant, property, and equipment). Stated another way, MVE is based on how assets, liabilities, and derivative positions would be priced in prevailing markets.[16] MVE captures the impact that changes in interest rates have on the net economic value of the institution even though it

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[13] While FTP has broader application within the System, this bookletter refers to the FTP process from the limited perspective of its use in pricing the bank's direct loans to associations and the resulting impact on association IRR exposures. FTP also refers to the pricing of direct loans to service corporations and other System institutions if they are funded and priced in the same manner as associations.

[14] Section 615.5182 extends the requirements of § 615.5180 to associations and other System institutions where IRR could lead to significant declines in net income or the market value of capital.

[15] Equity positioning can result in significant IRR. Equity reduces the amount of debt that otherwise would be required to match-fund each asset. If equity is concentrated in funding assets in certain time buckets, it can expose earnings or capital to significant IRR. For example, positioning all equity to fund the longest-term assets generally results in higher risk to MVE.

[16] For the base-case measurement of MVE, pricing is based on observable market prices and spreads or, if unavailable, estimated using market-derived factors.

may not be reflected in accounting or regulatory capital values. MVE is also a proxy for the future earnings capacity residing in the *existing* balance sheet and financial positions.[17]

Static balance sheet: IRR measurements using a static or constant balance sheet assume the size and composition of the balance sheet remain stable. Cash flows from maturing or amortizing assets and liabilities are rolled back into instruments from the same product category. Static measures are relatively standardized, involve fewer business assumptions, and enable comparisons to peers and an understanding of IRR changes over time.

Dynamic balance sheet: IRR measurements using a dynamic balance sheet incorporate business and strategic assumptions such as growth, business plan projections, and changes in spreads, asset mix, and liability mix. Dynamic measurements can help management assess the impact of strategic alternatives on risk and, when supplemented with static measures, provide a more complete description of IRR exposures. However, dynamic measures are more heavily dependent on business assumptions that are difficult to predict with accuracy over an extended time period. In addition, depending on the assumptions, dynamic measures can mask IRR exposures (e.g., income from assumed growth or widening spreads, or assumed management responses to changing interest rates, could offset the impacts of IRR).

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[17] MVE cannot be readily reconciled to subsequent reported earnings for a variety of reasons. In particular, MVE values the existing balance sheet, but in reality, new assets, liabilities, and off-balance sheet positions are constantly added as positions mature and roll off. Nonetheless, the higher the MVE, the more earnings can potentially be generated from the existing balance sheet in future periods.

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BOOKLETTER

January 19, 2021

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Glen R. Smith
Board Chairman and Chief Executive Officer

Subject: Criminal referral guidance (BL-073)

The Farm Credit Administration is issuing this bookletter to answer some of the most frequently asked questions about FCA's criminal referral regulations and filing requirements. This guidance clarifies our expectations for Farm Credit System (FCS or System) institutions regarding adherence to our criminal referral regulations and provides information on filing the Criminal Referral Form.[1]

Your institution must ensure timely reporting of known or suspected criminal activity. Your board of directors and senior management have a responsibility to establish and maintain safeguards to deter, detect, and report known or suspected criminal activity involving the assets, operations, or affairs of your institution. The board's internal controls, especially its policies and related guidance, should outline the processes for identifying and reporting known or suspected criminal activities by internal or external parties.[2]

FCA criminal referral regulations

The FCA criminal referral regulations promote consistency, efficiency, and timeliness by FCS institutions in reporting and aiding the prosecution of known or suspected criminal activities. The regulations are located at 12 C.F.R. 612, subpart B.[3] The following regulatory sections

[1] FCA's criminal referral regulations apply "to all institutions of the Farm Credit System as defined in Section 1.2(a) of the Farm Credit Act of 1971, as amended, (Act) (12 U.S.C. 2002(a)), including, but not limited to, associations, banks, service corporations chartered under section 4.25 of the Act, the Federal Farm Credit Banks Funding Corporation, the Farm Credit Leasing Services Corporation, and the Federal Agricultural Mortgage Corporation …" 12 C.F.R. 612.2300(a).

[2] See FCA Bookletter BL-069, Strengthening Lending and Loan Servicing Controls, dated March 8, 2018.

[3] In accordance with the Farm Credit Act of 1971, as amended, FCA regulates and examines FCS institutions for safety and soundness and for compliance with federal laws and regulations. Violations of federal laws and regulations could undermine public confidence in the System and affect the safety and soundness of System institutions. Federal law enforcement agencies need to receive timely and

describe the requirements you will need to be aware of when making a referral of known or suspected criminal activity:

- 612.2300 — Purpose and scope
- 612.2301 — Referrals
- 612.2302 — Notification of board of directors and bonding company
- 612.2303 — Institution responsibilities

Our regulations establish the minimum requirements your institution must follow when filing a criminal referral to federal law enforcement agencies of known or suspected criminal violations perpetrated against the institution by insiders or others, such as borrowers. One of the requirements is to use the FCA Criminal Referral System, to which a link is available from our Criminal referrals page, as well as section EM-1.5 (PDF) of our FCA Examination Manual.

"Known or suspected criminal activity" means there appears to be a **reasonable basis through discovery of relevant facts** of a known or suspected federal criminal violation. In making these determinations, your institution board and senior management must ensure an effective and timely criminal referral reporting process.

As we explain in the response to question 13 below, a director, officer, employee, agent, or other individual of your institution who makes a good-faith disclosure of information that may be relevant to a possible violation of any federal or state law or regulation is not liable to any person for the disclosure under any law of the United States or any state.

Frequently asked questions

1. What policies and procedures must my institution have regarding the criminal referral reporting process?

FCA regulation 612.2303 requires each System institution to establish policies and procedures to comply with the FCA criminal referral regulations, including adequate internal controls. Your institution's internal controls for the criminal referral program promote compliance with regulatory requirements and the criminal referral reporting process. Your institution should do the following:

- Establish policies and procedures for identifying and reporting known or suspected criminal activities in accordance with FCA criminal referral regulations. These policies and procedures should include, at a minimum, the following:
  - Designating an employee to oversee the criminal referral reporting process who is responsible for ensuring the Criminal Referral Form is completed and submitted. This individual should have direct access to your board or designated board committee.

specific information from System institutions on known or suspected criminal violations to determine whether investigations and prosecutions are warranted. See section 5.17(a)(10) of the Farm Credit Act.

- – Maintaining the confidentiality of information regarding known or suspected criminal activity and any referral of such activity. In accordance with your institution's whistleblower program, anyone who reports known or suspected criminal activity should not fear retribution.

- – Documenting the rationale for not filing a criminal referral if a reasonable person could question the decision. Such documentation must include your evaluation of atypical activity. Your institution should document the facts and circumstances related to atypical activity (e.g., borrower action inconsistent with the lending agreements) that give the institution a reasonable basis to conclude that no criminal activity has occurred.

- – Providing instructions for preparing, reviewing, and submitting the FCA Criminal Referral Form and preparing and reviewing related documentation that must be collected, organized, and retained in accordance with FCA Examination Manual Section EM-1.5 (PDF).

- – Retaining records of known or suspected criminal activity, including cases when a reasonable person could question why a referral was not pursued. Your institution should retain records in accordance with the FCA Criminal Referral Form and Instructions.[4] Ensure that all records are maintained to allow for possible federal prosecution of a known or suspected criminal violation within the statute of limitations. Federal law enforcement may require that criminal referral and supporting records be retained for longer than FCA does.

- Follow the requirements for promptly notifying your institution's board and bonding/insurance company under FCA regulation 612.2302[5] and the bonding/insurance contract.
- Establish a process for obtaining legal and other resources that may be needed to help your institution determine whether there appears to be a reasonable basis to file a criminal referral for a known or suspected criminal violation.
- Audit the criminal referral reporting process for compliance with FCA regulations and the instructions for filing the Criminal Referral Form. Identify and document any weaknesses and recommend necessary corrective actions to your institution's board or designated committee of the board.
- Train employees to comply with FCA criminal referral regulations, to follow the instructions for filing the Criminal Referral Form, and to follow your institution's criminal referral policies and procedures.

2. How does my institution identify a known or suspected violation of federal criminal law?

FCA regulations require your institution to submit a criminal referral if it determines that there appears to be a reasonable basis to conclude a known or suspected criminal violation

[4] Institutions should retain one copy of the FCA Criminal Referral Form, along with any supporting documents, for 10 years (the statute of limitations for most financial banking crimes), consistent with the requirements stated on the forms which are authorized in FCA regulation 612.2300(e).

[5] The notification requirement is usually defined in the bonding or insurance contract. A System institution must not provide a copy of the FCA Criminal Referral Form to the bonding or insurance company.

of the United States Code has occurred that involves the assets, operations, or affairs of the institution. When evaluating and reporting known or suspected criminal activity, you should, to the best of your ability, identify the facts that may be relevant to the known or suspected activity. Investigation is the responsibility of federal law enforcement.

However, if the facts show that the act was inadvertent and no relevant facts support the belief that suspected criminal activity occurred, you may not be required to file a referral. For instance, if the only relevant facts are that a person accidentally omitted a small liability or inadvertently inverted numbers on a financial statement or inadvertently sold an inconsequential amount of collateral, a referral may not be required based on those facts alone.

When deciding whether to file a criminal referral, your institution should consider all relevant facts, including the contractual agreements between your institution and the borrower(s). A collateral sale or exchange by one borrower may be considered criminal activity but not by another borrower because of the terms of the written contractual agreements between the parties or other facts and circumstances. For example:

- A written contractual agreement between the borrower and institution could allow collateral to be sold without prior approval of the institution when a similar item is purchased, and the new similar item automatically becomes collateral.
- An institution could have a collateral release agreement that provides for a written and enforceable release on the original collateral.
- The relevant written agreement could provide that the institution’s prior approval is always required for the sale of collateral.

Institutions are not required to prove the intent of the actor when intent is an element of a suspected crime. Instead, your institution should **consider whether all the relevant facts constitute a reasonable basis for filing a Criminal Referral Form**. You should not consider customer loyalty, threatened repercussions for filing a criminal referral, and other concerns not covered under the FCA criminal referral regulations. Objective analysis of every situation ensures your institution is treating all your borrowers equitably, including borrowers under the Young, Beginning, and Small Farmer Program, and protecting them from disparate treatment.

As an internal control, and in accordance with your institution’s policies and procedures, your institution should adequately document why a criminal referral was not filed if you conclude, on the basis of the relevant facts and circumstances, that the conduct in question was an isolated incident and does not constitute a basis for a criminal referral, and a reasonable person would not question the decision.

3. When must my institution file a criminal referral?

An FCA Criminal Referral Form must be filed within 30 calendar days of determining that there appears to be a reasonable basis to conclude a known or suspected criminal violation of the United States Code has occurred that involves the assets, operations, or affairs of the institution. FCA regulation 612.2301(a) provides applicable reporting thresholds for filing a criminal referral. The Criminal Referral Form must be filed promptly since the passage of time may inhibit law enforcement’s ability to act on the known or suspected criminal activity. Question 6 includes additional information on reporting thresholds when filing a criminal referral.

The following table summarizes the thresholds for potential loss you should use when filling out the Criminal Referral Form.

Type of Suspect	Threshold for Potential Loss	FCA Regulation
Insider (director, employee, or agent)	Any amount	612.2301(a)(1)
Identifiable suspect	>$5,000	612.2301(a)(2)
Unidentifiable suspect	>$25,000	612.2301(a)(3)

Your institution must apply these thresholds for all known or suspected criminal activity, including conduit-related transactions (i.e., when your institution has been used as a conduit for transferring funds). See question 10 for additional information on this topic.

FCA regulations require institutions to immediately notify federal law enforcement authorities and the FCA Office of Examination at (888) 244-3365 in special situations requiring urgent attention. Such cases include the following:

- The suspect or suspects are likely to flee.
- The magnitude or the continuation of the known or suspected criminal violation may imperil your institution's continued operation.
- Key personnel at your institution are involved.

In some situations, the facts supporting a criminal referral may unfold over time. In these cases, your institution must file a referral within 30 days of the initial discovery when there is a reasonable basis to conclude there is known or suspected criminal activity. You may file an updated Criminal Referral Form if relevant facts or circumstances are discovered after your initial filing.

4. How can my institution make a criminal referral more persuasive?

You must fill out the Criminal Referral Form according to the criminal referral instructions in the Examination Manual. Your criminal referral may be more persuasive in convincing federal law enforcement to investigate when you include a detailed narrative commensurate with the seriousness of the offense. The criminal referral should be fact based and avoid any unsubstantiated information or opinions on the criminal activity or the subject's guilt.

The preparer's comments should describe the relevant facts of a known or suspected federal criminal violation, including the following:

- Identity of the person(s) involved in the criminal activity
- Type of criminal activity

- Pattern or frequency of a known or suspected criminal activity, including the dates of each occurrence
- Name and location of the institution where the criminal activity occurred
- Account number(s) and account type(s) involved in the transaction(s)
- Reasons the criminal activity (or pattern of activities) drew your institution's suspicion

5. *Should my institution file a referral on minor criminal violations?*

It depends. Your institution may make referrals on minor criminal violations when the dollar amount of the actual or potential loss is less than the reporting threshold amount in accordance with FCA regulation 612.2300(c). Reporting this type of violation is particularly relevant when a borrower may have repeated criminal activities, such as several instances of diverting or converting collateral, in which the individual amounts involved are less than the reporting threshold amount.

6. *How should my institution determine if the reporting threshold has been met?*

The FCA criminal referral regulations do not require your institution to sustain an actual loss to trigger your obligation to file a criminal referral. The "potential for loss" satisfies the regulatory requirement of a threshold amount for filing a criminal referral. Your institution may not consider a borrower's financial condition, tenure with the institution, capacity to repay, or collateral value when calculating the potential loss.

When analyzing the potential for loss, you must include the following as part of your analysis:[6]

- Calculate the potential for loss on the basis of a reasonable assessment at the time of discovery of known or suspected criminal activity.
- Calculate the loss before recovery or reimbursement to determine the total loss.
- Estimate the range of the potential loss if an exact amount cannot be determined. A criminal referral is required if any part of the range exceeds the applicable threshold.

For example:

- You must calculate loss on the basis of the potential loss to the institution even if a borrower satisfies the debt after the criminal activity occurred.
- If a borrower is engaged in criminal activity and was denied credit by your institution, you must calculate the loss on the basis of the potential loss to your institution if the loan had been extended. In many cases, the potential loss would be the value of the loan if it had been extended.
- If a borrower has misstated his or her financial statements or converted collateral valued at more than $5,000, the borrower has engaged in criminal (or suspected criminal) activity, regardless of whether the loan is well secured and has adequate repayment capacity. In this case, your institution must file a Criminal Referral Form.

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[6] There is no need to define and analyze the loss amount for an insider since there is no reporting threshold and all criminal activity must be reported.

- If your institution was used as a conduit for transferring funds, you must determine the potential loss to your institution regardless of the borrower's pledged collateral, line of credit, or ability to recover the funds. See question 10 for additional information on conduit-related transactions.

7. Should my institution file a criminal referral when there is a pattern of known or suspected federal criminal violations, but each individual act does not exceed the reporting threshold amount?

Your institution should file a criminal referral when the amounts resulting from these repeated violations add up to a loss that equals or exceeds the reporting threshold amount. The discovery of relevant facts must provide a reasonable basis to conclude such a pattern exists.

8. Are overstated financial statements provided by the borrower considered a "false financial statement"?

It depends. Your institution should review the relevant facts and circumstances to determine whether the omitted credit or falsified financial statement had a material impact on the credit decision and whether it was an isolated incident or the borrower repeatedly distorts financial statements. For instance, you should consider whether the borrower omitted a small loan or overstated the value of assets by a significant amount to induce a favorable lending decision.

If your designated officer or employee determines the relevant facts and circumstances show that the omission or misstatement was not material and was in fact an isolated incident, your decision not to file a criminal referral must be documented because a reasonable person could question the decision.

9. What action(s) should my institution take if a collateral conversion or false financial information is discovered after my institution begins the distressed loan notification process with a borrower?

FCA borrower rights regulations do not affect your institution's criminal referral reporting obligations. Our criminal referral regulations require an institution to act separate and apart from our borrower rights regulations. However, you should consider other actions that may be needed to protect your institution's financial interests.

10. What action(s) should my institution take if it was used as a conduit for criminal activity?

Your institution must file a criminal referral when it is used as a conduit to perpetrate a known or suspected financial crime.

FCA regulations 612.2301(a)(1) through (3) establish the monetary thresholds that should be applied when an institution is used as a conduit. The thresholds are as follows:

- A loss of any amount when the suspect is an insider
- A loss of over $5,000 when the suspect is identifiable but is not an insider (e.g., a borrower)
- A loss of over $25,000 when the suspect is unknown

You should determine loss on the basis of the potential loss to the institution. See question 6 for additional information on analyzing loss or a potential for loss to determine if the reporting threshold has been met.

For example, your institution should file a criminal referral if a borrower attempts to cash a check over $5,000 drawn on a fake account even if your institution does not process the check. Your institution should also file a criminal referral when it receives a fraudulent wire transfer request from an unknown person for over $25,000 even if your institution does not transfer the money. In both instances, there was an attempt to use the institution as a conduit in transferring money, and your institution's assets, operations, or affairs were involved or affected by these actions.

Generally, each System institution affected by a known or suspected federal criminal violation is responsible for filing a criminal referral; however, there are exceptions. Many conduit-related criminal referrals involve multiple System parties. For example, a Farm Credit System bank may provide cash management services for an association. In this case, one institution may be designated to file the referral on behalf of all institutions since there are no confidentiality issues. The responsibility for filing should be clearly defined between the parties. A copy of the referral should be shared with each institution involved in the known or suspected criminal activity. If the institutions do not file a coordinated criminal referral report, each institution must file a separate Criminal Referral Form.

11. Do loan participations present any special issues?

Yes, loan participations present special issues concerning legal jurisdictions and reporting responsibilities. In a case involving loan participations, one System institution may be designated to file the referral on behalf of all System participants. The institution filing the Criminal Referral Form should make its best effort to file it in the jurisdiction(s) where the known or suspected criminal activity took place. The filing institution should share a copy of the referral with all participating institutions. If the institutions do not file a coordinated criminal referral report, each institution must file an individual Criminal Referral Form. Sharing information between institutions who are loan participants is appropriate in this instance because the activity affects all the participating institutions, and cooperation is likely necessary to file a complete and effective criminal referral.[7]

12. Are criminal referrals confidential?

Yes, criminal referrals are confidential and should not be disclosed to anyone other than government entities and law enforcement agencies. FCA regulations at 12 CFR part 618, subpart G, provide specific information concerning the release of confidential borrower and applicant information. This confidentiality requirement is further defined in FCA regulation 612.2302. FCA also maintains the confidentiality of criminal referrals.

If your institution is subpoenaed or asked by a nongovernment entity or individual to disclose a criminal referral or related information, you should cite FCA's information release regulations at 12 CFR part 618, subpart G. You should notify the FCA Office of General Counsel of any requests or subpoenas for information related to a Criminal Referral Form. In addition, your institution should not inform the borrower or suspect of the contents of the

[7] See FCA regulation 618.8320(b)(4).

Criminal Referral Form, related information, or the status of your filing with law enforcement authorities.

13. Can I be held liable for making a criminal referral? What are the safe harbor provisions?

It depends. Your institution and its personnel have immunity from liability if the criminal referral was reported in good faith. Under 12 U.S.C. § 2219e, any institution and its personnel who file a criminal referral with the appropriate federal or state law enforcement authority in good faith will not be liable to any person for the disclosure of the relevant information or for failing to notify the person involved in the possible violation. The FCA Criminal Referral Form and filing instructions include this information.

Further, your institution and any director, officer, employee, agent, or other individual of your institution may disclose information in confidence to a government authority if the information is relevant to a possible violation of any law or regulation. Fear of reprisal, litigation, or reputation risk should not keep anyone from filing a criminal referral.

14. Does a law enforcement inquiry or civil subpoena for borrower loan documents trigger the requirement to make a criminal referral?

No, an institution's receipt of a law enforcement inquiry or civil subpoena for a borrower's loan documents does not, by itself, require the filing of a criminal referral. However, a law enforcement inquiry or a civil subpoena may be relevant to your institution's decision to review account activity for the borrower and determine whether a criminal referral is required. If you encounter this situation, you may want to consult with your counsel and with the FCA Office of General Counsel. Also, see questions 12 and 13, which both discuss the confidentiality of criminal referrals.

15. How should my institution file a criminal referral with FCA?

You must use the FCA Criminal Referral System to file a criminal referral. You can access the system from FCA's Criminal referrals webpage. After you sign in to the system, you will be immediately redirected to the FCA Criminal Referral Form and Instructions. This system provides the copy of the criminal referral to FCA's Office of General Counsel, as required by regulation.

When filing with FCA, do not include any supporting documentation. You must retain supporting documentation in accordance with the FCA Criminal Referral Form and Instructions. Do not send emails, faxes, paper submissions, or courtesy copies to FCA's Office of General Counsel or other FCA employees.

The instructions list the federal law enforcement authorities with whom you should file your referral, depending on the type of violation involved.

16. Can my institution use its discretion to decide not to file a criminal referral?

No, your institution does not have discretion to decide not to file if a known or suspected criminal activity meets the reporting threshold. You may not decide on your own whether a criminal referral is required, even if you assume that there will be no prosecution. The response to question 2 can help you determine whether there is a reasonable basis to conclude that a known or suspected federal criminal violation has occurred.

17. What happens if FCA finds my institution did not file a criminal referral?

Failure to comply with the FCA criminal referral regulations may subject an institution, as well as its employees and directors, to supervisory or enforcement actions, including civil money penalties.

18. What should I do if anyone discourages me from filing a criminal referral or otherwise interferes with the process?

You should consult your institution's whistleblower program and file a complaint on the basis of the relevant facts and circumstances used to discourage you from filing the criminal referral.

19. Should my institution train credit staff, senior management, legal staff, and others to identify known or suspected suspicious criminal activity?

Yes, your institution should conduct criminal referral training at least annually. The training should be consistent with FCA criminal referral regulations, this bookletter, and your institution's criminal referral policies and procedures.

20. Can my institution file a suspicious activity report under the Bank Secrecy Act instead of a Criminal Referral Form?

No, System institutions are not subject to the Bank Secrecy Act and should not file a suspicious activity report.[8]

21. What notifications of criminal activity must my institution make to state or local law enforcement?

Your institution must notify state or local law enforcement authorities if you determine there is a reasonable basis to conclude there is a known or suspected criminal violation of state or local law, including robbery or burglary (committed or attempted). Your institution should use whatever method it deems appropriate to make the notification and should notify its FCA examiner-in-charge if the reported violation is material. Your institution is not required to file the FCA Criminal Referral Form with federal law enforcement for criminal activity that only qualifies as a state or local offense.

22. What if a borrower or insider is suspected of committing crimes that are not related to my institution's business?

Your institution is not required to file a Criminal Referral Form if a borrower or an insider is suspected of committing crimes that are not related to your institution's business. Your institution also is not required to report these crimes to state or local law enforcement.

However, you should consider how continuing a relationship with such a borrower or insider may affect your business.[9] For example, your institution may know or suspect that a

[8] Even though System institutions are required by regulation to file an FCA Criminal Referral Form, they may also voluntarily file a suspicious activity report with the Financial Crimes Enforcement Network.

[9] Also, see FCA's standards of conduct regulations at 12 CFR part 612, subpart A.

borrower or insider has committed a crime involving drugs or retail theft. While these crimes do not directly relate to your institution's business, they are violations of state or local laws and could affect the borrower's or insider's continued relationship with your institution. Further, discovering a borrower's involvement in such activities may affect your institution's evaluation of the borrower's creditworthiness, risk rating, and servicing requirements.

23. Whom should my institution contact if we have additional questions about FCA's criminal referral regulations?

Please contact FCA's Office of General Counsel at (703) 883-4020 or Office of Regulatory Policy at (703) 883-4498.