

Informational Memorandum



June 17, 2008

To: Chief Executive Officer
All Farm Credit System Institutions

From: Andrew D. Jacob, Director
Office of Regulatory Policy

A handwritten signature in black ink that reads "Andrew D. Jacob".

Subject: Capital Adequacy – Risk Weighting of Certain Off–Balance Sheet Exposures

The Farm Credit Administration (FCA or we) issues this informational memorandum (IM) to provide guidance to Farm Credit System (System) institutions for determining regulatory capital treatment of certain off–balance sheet exposures, specifically commitments, letters of credit, direct credit substitutes, and recourse obligations. FCA Regulation § 615.5212(a) prescribes how off–balance sheet items are generally incorporated into risk-weighted assets: (1) The off–balance sheet exposure is multiplied by a credit conversion factor (CCF) as set forth in § 615.5212 to determine its on–balance sheet credit equivalent; and (2) the on–balance sheet credit equivalent is assigned to an appropriate risk-weight category according to the obligor or, if relevant, the guarantor or the collateral, as directed in § 615.5211. The FCA applies this approach based on inherent risks in the off–balance sheet item as opposed to how the item might be characterized or labeled. This IM provides guidance on our regulatory definitions of certain off–balance sheet items and examples of how such items should be risk-weighted for determining regulatory capital requirements.

Commitments

Commitments are arrangements that legally obligate an institution to purchase loans or securities, to participate in loans or leases, to extend credit in the form of loans or leases, to pay the obligation of another, to provide overdraft, revolving credit, or underwriting facilities, or to participate in similar transactions.¹ Commitments are generally prearranged lines of credit or obligations to provide a borrower with funding in the future. They expire in one of two ways: 1) All funds are drawn, and the outstanding commitment is reduced to zero when the resulting loan is booked; or 2) the commitment reaches its stated maturity, in which case it ceases to be binding on either party.

¹ 12 C.F.R. § 615.5201. See also 12 C.F.R. § 614.4350.

Commitments should not be confused with letters of credit (described below), which require certain trigger events before funding is needed. In the preamble to our 1988 final rule implementing the current risk-based capital framework for the System, we explained the differences between a loan commitment and a standby letter of credit.² A loan commitment is an obligation of the financial institution to provide funds to its customer in the normal course of business should the customer seek to draw down the commitment. As discussed below, a standby letter of credit is an obligation of a financial institution to pay a third-party beneficiary when its customer fails to repay an outstanding loan or debt instrument or fails to perform some other contractual obligation. The distinguishing characteristic of a standby letter of credit is the combination of irrevocability with the notion that funding is triggered by some failure to repay or perform on an obligation. Any commitment (by whatever name) that has this distinguishing characteristic would be treated, for the purposes of determining regulatory capital, as a standby letter of credit and not as a commitment.

As prescribed under § 615.5212, unused commitments with an original maturity of 14 months or less are assigned a zero percent CCF. Unused commitments with an original maturity of greater than 14 months can also receive a zero percent CCF provided the commitment is unconditionally cancelable³ and the System institution has the contractual right to (and in fact does) make a separate credit decision before each drawing under the lending arrangement. All other unused commitments with an original maturity of greater than 14 months are assigned a 50 percent CCF.

Example 1: Capital Treatment for Commitments⁴

A System institution provides the following commitments to its customers:

- Borrower 1 (B1) receives a \$50,000 loan commitment that expires in 12 months, at which time the System institution is no longer bound to the commitment.
- Borrower 2 (B2) receives a \$50,000 loan commitment that is *not* unconditionally cancelable by the System institution and has an original maturity greater than 14 months, at which time the institution is no longer bound to the commitment.
- Borrower 3 (B3) receives a \$50,000 loan commitment that is unconditionally cancelable by the System institution (and meets the other regulatory requirement specified in § 615.5212(b)(1)(ii)(B)).

² See 53 FR 39229 (Oct. 6, 1988).

³ An unconditionally cancelable commitment is one that can be canceled for any reason at any time without prior notice.

⁴ Except where otherwise indicated, all examples in this IM assume the obligation is for other than qualified residential loan purposes.

The regulatory capital requirement calculation for the commitments would be as follows:

	Step 1: The commitment amount is multiplied by the appropriate CCF as set forth in § 615.5212 to determine its on-balance sheet credit equivalent.			Step 2: The on-balance sheet credit equivalent is multiplied by the appropriate risk-weight category as directed in § 615.5211 to determine its risk-adjusted asset amount.		Each System institution must maintain permanent capital (PC) at a level of at least 7 percent of its risk-adjusted asset base as set forth in § 615.5205.	
	Commitment Amount	CCF	On-BS Credit Equivalent	Risk-Weight Category¹	Risk-Adjusted Asset Amount	PC	Minimum Capital Requirement
B1	\$50,000	0%*	\$0	100%*	\$0	7%	\$0
B2	\$50,000	50%**	\$25,000	100%*	\$25,000	7%	\$1,750
B3	\$50,000	0%***	\$0	100%*	\$0	7%	\$0
Total					\$25,000		\$1,750
	* 615.5212(b)(1)(i) ** 615.5212(b)(3)(ii) *** 615.5212(b)(1)(ii)			* We assume in this example that the credit risk classification of all obligors is 100%. See § 615.5211(d).			

¹ The risk weight is based on the risk classification of the obligor. If the commitment is guaranteed or backed by collateral, the guaranteed or collateralized portion of the on-balance sheet equivalent would be assigned a risk weight according to the guarantor or collateral.

Letters of Credit

Letters of credit are written promises made by an issuer on behalf of its customer to make a payment to a named third-party beneficiary under certain circumstances. A letter of credit generally defines the circumstances that will trigger the payment. The FCA classifies letters of credit as commercial or standby.

Commercial letters of credit are instruments used to facilitate commercial transactions. They are generally short-term payment mechanisms used for trade finance. The financial institution issuing a commercial letter of credit acts as an intermediary between buyers and sellers. For example, a buyer (account party) agrees to buy goods from a seller (third-party beneficiary) and applies to a financial institution for a letter of credit. The financial institution issues the letter of credit on behalf of the account party and sends it to the third-party beneficiary. Upon receipt of the letter of credit, the third-party beneficiary ships the goods to the account party. The financial institution pays the third-party beneficiary on behalf of the account party when the terms of the letter of credit are met and it has received required supporting documents. The financial institution usually retains title to the goods being shipped until the account party reimburses the issuer for payment made to the third-party beneficiary.

Standby letters of credit are obligations of an issuer (e.g., System institution) to make payments on behalf of its customer (account party) to a specified third-party beneficiary.⁵ These obligations can include repayment of money that has been borrowed by or advanced to an account party. For example, if an account party defaults on an obligation to a third-party beneficiary, the issuer guaranteeing the performance of the account party's obligation must make a payment as specified in the standby letter of credit. Although they may arise from a

⁵ The FCA defines standby letters of credit in 12 C.F.R. § 615.5201 under the terms "performance-based standby letter of credit" and "financial standby letter of credit."

commercial transaction, standby letters of credit are not linked directly to trade finance. They are guarantees of payment in the event of default or nonperformance by the account party. Standby letters of credit generally carry more risk than commercial letters of credit transactions because the issuer usually retains nothing of value to protect against loss. The FCA identifies two types of standby letters of credit: performance-based and financial letters of credit. Most standby letters of credit are financial in nature.

Performance-based standby letters of credit⁶ are irrevocable obligations to the third-party beneficiary on the part of the issuer to make payment as a result of any default by the account party in the performance of a nonfinancial or commercial obligation.⁷ The event that triggers payment is performance-related, such as the account party's failure to ship a product or provide a service. Examples might include arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

Financial standby letters of credit are irrevocable obligations of the issuer to repay money borrowed by, advanced to, or for the account of, the account party, or to make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the third-party beneficiary.⁸ The event that triggers payment is financially related: the account party fails to pay money under a contractual obligation.

As prescribed under § 615.5212, commercial letters of credit are assigned a 20 percent CCF, and performance-based standby letters of credit are assigned a 50 percent CCF. Financial standby letters of credit are direct credit substitutes⁹ (see below) and are assigned a 100 percent CCF.

Example 2: Capital Treatment for Letters of Credit

A System institution issues the following letters of credit to its customers:

- Agribusiness 1 (A1) obtains a letter of credit from a foreign buyer to facilitate the purchase of \$1 million in exports from A1. A1 assigns the letter of credit to the System institution. The System institution finances the purchase, and A1 ships its product to the foreign buyer. When the foreign buyer makes payment, the System institution deducts all expenses incurred and the balance is forwarded to A1.
- Agribusiness 2 (A2) promises its customer that goods will be shipped on a certain date. Failure to deliver the goods on the agreed-upon date shuts down the customer's production. A2 obtains a letter of credit to ensure its customer that goods will be delivered on that date. The System institution commits or promises to pay A2's customer \$1 million in production costs on behalf of A2 in the event it fails to ship the product on the promised date.
- Agribusiness 3 (A3) obtains a letter of credit to support a \$1 million loan. If A3 defaults on the loan, the System institution promises to pay the full amount of the loan.

The regulatory capital requirement calculation for the letters of credit would be as follows:

	Step 1: The dollar amount of the	Step 2: The on-balance	Each System
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⁶ This type of letter of credit is not common in the System.

⁷ 12 C.F.R. § 615.5201.

⁸ 12 C.F.R. § 615.5201.

⁹ The definition of direct credit substitute includes financial standby letters of credit. See § 615.5201 (Definition of direct credit substitute (1)).

		credit risk assumed by the letter of credit is multiplied by the appropriate CCF as set forth in § 615.5212 to determine its on-balance sheet credit equivalent.			sheet credit equivalent is multiplied by the appropriate risk-weight category as directed in § 615.5211 to determine its risk-adjusted asset amount.		institution must maintain PC at a level of at least 7 percent of its risk-adjusted asset base as set forth in § 615.5205.	
	Type of Letter of Credit	\$ Amount of Credit Risk Assumed	CCF	On-BS Credit Equivalent	Risk-Weight Category ¹	Risk-Adjusted Asset Amount	PC	Minimum Capital Requirement
A1	Commercial	\$1,000,000	20%*	\$200,000	100%*	\$200,000	7%	\$14,000
A2	Performance standby	\$1,000,000	50%**	\$500,000	100%*	\$500,000	7%	\$35,000
A3	Financial standby	\$1,000,000	100%***	\$1,000,000	100%*	\$1,000,000	7%	\$70,000
Total		\$3,000,000		\$1,700,000		\$1,700,000		\$119,000
		* 615.5212(b)(2) ** 615.5212(b)(3)(i) *** 615.5212(b)(4)(1). Financial standby letters of credit are direct credit substitutes as defined in § 615.5201.			* We assume in this example that the credit risk classification of all obligors is 100%. See § 615.5211(d).			

¹ The risk weight is based on the risk classification of the obligor. If the letter of credit is guaranteed or backed by collateral, the guaranteed or collateralized portion of the on-balance sheet equivalent would be assigned a risk weight according to the guarantor or collateral.

Direct Credit Substitutes

Under § 615.5201, direct credit substitutes are arrangements in which an institution assumes, in form or in substance, credit risk directly or indirectly associated with an on- or off-balance sheet asset or exposure that was not previously owned by the institution (third-party asset) and the risk assumed by the institution exceeds the pro rata share of the institution's interest in the third-party asset. If the institution has no claim on the third-party asset, then the institution's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include, but are not limited to, financial standby letters of credit, guarantees, surety arrangements, credit derivatives, purchased subordinated interests, loans or lines of credit that provide credit enhancement, purchased loan-servicing assets, and clean-up calls on third-party assets.¹⁰

Example 3: Direct Credit Substitute

A System institution provides a (non-externally rated) standby bond purchase agreement (SBPA) to support a \$100 million bond portfolio consisting of \$50 million in privately issued (PI) bonds and \$50 million in public sector entity (PSE) bonds backed by the full faith and credit of the PSE.¹¹ The SBPA serves two essential functions: 1) it enhances the credit rating of the bonds in the portfolio and 2) it unconditionally guarantees the purchase of the bond portfolio in the event the issuer is unable to sell the bonds to outside investors. The SBPA meets the definition of a direct credit substitute (DCS) because it "assumes" the credit risk associated with

¹⁰ 12 C.F.R. § 615.5201

¹¹ The term "public sector entity" (PSE) is commonly used to refer to entities such as political subdivisions below the central government level. See, e.g., proposed rule of the other financial regulatory agencies at 71 FR 77451, footnote 18 (Dec. 26, 2006); 2004 New Basel Capital Accord (Basel II) and 2005 and 2006 updates, at www.bis.org/publ/bcbsa.htm. FCA does not currently use this terminology in its regulations but captures the concept by referring to states or other political subdivisions of the United States or other Organization for Economic Cooperation and Development countries. See e.g., 12 C.F.R. § 615.5211(b)(9), 12 C.F.R. § 615.5211(c)(4), and 12 C.F.R. § 615.5211(d)(4).

the bond portfolio. Credit risk transfers from the bond portfolio to the System institution that provides the SBPA, resulting in a higher credit rating for the portfolio.¹² Consequently, the System institution is required to hold capital for its contractual exposure. We specify in our regulations that the full amount of the assets supported by the DCS for which the System institution directly or indirectly assumes credit risk would be converted to an on-balance sheet equivalent.¹³ The regulatory capital requirement calculation for the DCS would be as follows:

	Step 1: The full amount of assets supported by the DCS is multiplied by the appropriate CCF as set forth in § 615.5212 to determine its on-balance sheet credit equivalent.			Step 2: The on-balance sheet credit equivalent is multiplied by the appropriate risk-weight category as directed in § 615.5211 to determine its risk-adjusted asset amount.		Each System institution must maintain PC at a level of at least 7 percent of its risk-adjusted asset base as set forth in § 615.5205.	
Off-BS Exposure	\$ Amount of Credit Risk Assumed	CCF	On-BS Credit Equivalent	Risk-Weight Category¹	Risk-Adjusted Asset Amount	PC	Minimum Capital Requirement
PI	\$50,000,000	100%*	\$50,000,000	100%*	\$50,000,000	7%	\$3,500,000
PSE	\$50,000,000	100%*	\$50,000,000	20%**	\$10,000,000	7%	\$700,000
Total					\$60,000,000		\$4,200,000
	* 615.5212(b)(4)(i).			* 615.5211(d)(1). ** We assume in this example that the PSE is a local government entity. See § 615.5211(b)(9).			

¹ The risk weight is based on the risk classification of the obligor. If the DCS is guaranteed or backed by collateral, the guaranteed or collateralized portion of the on-balance sheet equivalent would be assigned a risk weight according to the guarantor or collateral.

If the System institution subsequently purchases a portion of the bonds in the portfolio, the DCS would no longer apply to that portion. For example, if the System institution purchased the \$50 million in PI bonds, those bonds would become on-balance sheet assets and risk-weighted in accordance with § 615.5211. The remaining portion (e.g., the portion that exceeds the pro rata share of the institution's on-balance sheet interest in the bond portfolio) would be converted into an on-balance sheet credit equivalent. In this example, the DCS continues to support the \$50 million in PSE bonds. The regulatory capital requirement calculation for the DCS would be as follows:

¹² The degree of credit risk is reflected in the issuer's credit rating. The fact that the issuer receives a more favorable credit rating demonstrates that risk transference has been achieved (Risk transference can also take place without necessarily increasing a credit risk rating).

¹³ See § 615.5212(b)(4)(i).

	Step 1: Same as above			Step 2: Same as above		Same as above	
Off-BS Exposure	\$ Amount of Credit Risk Assumed	CCF	On-BS Credit Equivalent	Risk-Weight Category ¹	Risk-Adjusted Asset Amount	PC	Minimum Capital Requirement
PSE	\$50,000,000	100%*	\$50,000,000	20%*	\$10,000,000	7%	\$700,000
	* 615.5212(b)(4)(i).			* 615.5211(b)(9).			
	The PI bonds are treated as on-balance sheet assets.			The asset is multiplied by the appropriate risk-weight category as directed in § 615.5211 to determine its risk-adjusted asset amount.		Same as above	
On-BS Asset	On Balance Sheet Asset Amount		Risk-Weight Category ¹	Risk-Adjusted Asset Amount	PC	Minimum Capital Requirement	
PI	\$50,000,000		100%*	\$50,000,000	7%	\$3,500,000	
				* 615.5211(d)(1).			

¹ The risk weight is based on the risk classification of the obligor. If the DCS is guaranteed or backed by collateral, the guaranteed or collateralized portion of the on-balance sheet equivalent would be assigned a risk weight according to the guarantor or collateral.

Example 4: Direct Credit Substitute with Subsequent Participations

Using the information from the third example, the System institution (S1) provides a SBPA to support a \$100 million bond portfolio consisting of \$50 million in PI bonds and \$50 million in PSE bonds and subsequently sells three 25 percent risk participations to other System institutions (S2, S3, S4). For risk participations in such arrangements acquired by a System institution, § 615.5212(b)(4)(i) provides that the conversion factor is based on “the full amount of assets supported by the main obligation multiplied by the acquiring institution’s percentage share of the risk participation.” For the original System institution and each of the three acquiring institutions, the regulatory capital requirement calculation for the participated DCS would be as follows:

		Step 1: Same as above			Step 2: Same as above		Same as above		
	Off-BS Exposure	\$ Amount of Credit Risk Assumed	CCF	On-BS Credit Equivalent	Risk-Weight Category ¹	Risk-Adjusted Asset Amount	PCR	Minimum Capital Requirement	Totals
S1	PI	\$12,500,000	100%*	\$12,500,000	100%*	\$12,500,000	7%	\$875,000	
	PSE	\$12,500,000	100%*	\$12,500,000	20%**	\$2,500,000	7%	\$175,000	\$1,050,000
S2	PI	\$12,500,000	100%*	\$12,500,000	100%*	\$12,500,000	7%	\$875,000	
	PSE	\$12,500,000	100%*	\$12,500,000	20%**	\$2,500,000	7%	\$175,000	\$1,050,000
S3	PI	\$12,500,000	100%*	\$12,500,000	100%*	\$12,500,000	7%	\$875,000	
	PSE	\$12,500,000	100%*	\$12,500,000	20%**	\$2,500,000	7%	\$175,000	\$1,050,000
S4	PI	\$12,500,000	100%*	\$12,500,000	100%*	\$12,500,000	7%	\$875,000	
	PSE	\$12,500,000	100%*	\$12,500,000	20%**	\$2,500,000	7%	\$175,000	\$1,050,000
Total		\$100,000,000		\$100,000,000		\$60,000,000			\$4,200,000
		* 615.5212(b)(4)(i).			* 615.5211(d)(1).				
					** 615.5211(b)(9).				

¹ The risk weight is based on the risk classification of the obligor. If the DCS is guaranteed or backed by collateral, the guaranteed or collateralized portion of the on-balance sheet equivalent would be assigned a risk weight according to the guarantor or collateral.

Recourse Obligations

Under § 615.5201, recourse obligations are arrangements in which an institution retains, in form or in substance, credit risk directly or indirectly associated with an asset it has sold (in accordance with GAAP) that exceeds a pro rata share of the institution's claim on the asset. If an institution has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when an institution transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. It may also exist implicitly if an institution provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to, credit-enhancing representations and warranties made on transferred assets, loan-servicing assets retained, retained subordinated interests, assets sold under an agreement to repurchase, loan strips sold without contractual recourse, credit derivatives, and clean-up calls on assets sold.¹⁴

Example 5: Recourse and Residual Interest

A System institution sells \$100 million in qualified residential loans to a special purpose vehicle (SPV), which subsequently issues five classes of tranches of securities to fund the purchase of the loans. The four senior tranche positions are sold to investors, and the System institution retains a \$2 million unrated first loss tranche position (i.e., residual interest). To increase the credit rating of the senior tranche positions, the System institution agrees to repurchase up to \$20 million in loans resulting from default of payment of principal or interest (i.e., a non-externally rated recourse obligation). The regulatory capital requirement calculation for the unrated first loss tranche position and recourse obligation would be as follows:

	Step 1: The amount of credit risk retained by the recourse obligation is multiplied by the appropriate CCF as set forth in § 615.5212 to determine its on-balance sheet credit equivalent.			Step 2: The on-balance sheet credit equivalent is multiplied by the appropriate risk-weight category as directed in § 615.5211 to determine its risk-adjusted asset amount.		Each System institution must maintain PC at a level of at least 7 percent of its risk-adjusted asset base as set forth in § 615.5205.	
Off-BS Exposure	\$ Amount of Credit Risk Retained	CCF	On-BS Credit Equivalent	Risk-Weight Category¹	Risk-Adjusted Asset Amount	PC	Minimum Capital Requirement
Recourse Obligation	\$20,000,000	100%*	\$20,000,000	50%*	\$10,000,000	7%	\$700,000
	* 615.5212(b)(4)(i).			* 615.5211(c)(2).			
	The \$2 million unrated first loss tranche position is an on-balance sheet item.			The System institution must hold dollar-for-dollar capital in an unrated retained subordinated interest position that is part of a securitization transaction as prescribed in § 615.5210(c)(1).			
On-BS Asset	On-Balance Sheet Asset Amount			Dollar-for-Dollar Minimum Capital Requirement			
Residual Interest	\$2,000,000*			\$2,000,000			
	* 615.5201—residual interest (2)						

¹ The risk weight is based on the risk classification of the obligor. If the recourse obligation is guaranteed or backed by collateral, the guaranteed or collateralized portion of the on-balance sheet equivalent would be assigned a risk weight according to the guarantor or collateral.

¹⁴ 12 C.F.R. § 615.5201

The examples provided in this IM are for guidance purposes only and are not intended to reflect the unique off-balance sheet transactions conducted by System institutions. We emphasize that the FCA determines regulatory capital requirements for off-balance sheet exposures based on inherent risks in off-balance sheet items as opposed to how such items are characterized or labeled. The FCA can exercise its reservation of authority as defined in § 615.5210(f) to modify the risk-weighting requirement for any asset or off-balance sheet item when its capital treatment does not accurately reflect its associated risk. It should also be noted that the FCA is currently considering possible modifications to its risk-based capital rules and the guidance provided in this IM is subject to change. If you have questions in regard to the examples posed in this IM or need guidance on risk-weighting other off-balance sheet transactions, please contact Wade Wynn, Office of Regulatory Policy, at (703) 883-4262 or wynnw@fca.gov, or Jennifer Cohn, Office of the General Counsel, at (703) 883-4028 or cohnj@fca.gov, or me at (703) 883-4356 or jacoba@fca.gov.