FARM CREDIT ADMINISTRATION
EXECUTIVE SUMMARY

Subject: Rural Community Investments
Proposed Rule
Project No. 329203

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Issue: Whether the FCA Board should adopt the proposed rule to authorize Farm Credit System (FCS or System) banks, associations, and service corporations (hereafter "institutions") to purchase and hold investments in rural communities.

Previous Actions: None

Recommendation: We recommend that the FCA Board adopt the draft proposed rule by approving the following resolution:

> The Farm Credit Administration (FCA) Board hereby approves the attached proposed rule that would create a new FCA regulation, § 615.5176, to authorize Farm Credit System institutions to purchase and hold investments in rural communities. The FCA Board also authorizes the staff to make any technical, grammatical, or syntactical changes that may be necessary prior to publication in the *Federal Register*.

Background: The proposed rule is designed to provide FCS institutions with greater flexibility to partner with government agencies and with other rural lenders to invest in rural community development consistent with the System's statutory mission. Several provisions of the Farm Credit Act of 1971, as amended (Act), authorize FCS institutions to make investments that the FCA approves. The preamble to the Act explicitly states that the mission of the farmer-owned FCS is "to provide for an adequate and flexible flow of money into rural areas." Based on this statutory framework, the FCA, through regulations and pilot programs, has permitted System institutions to make investments in rural communities under certain conditions. In implementing the investment provisions of the Act, the FCA has taken an incremental approach since 1971 in approving System investments for mission-related purposes. These FCA regulations guide investment practices at FCS institutions and ensure that System investments comply with law and are safe and sound.

Since 2005, the FCA has approved requests by System banks and associations, on a case-by-case basis, to initiate pilot programs for making specific investments in America's rural communities. Under these pilot programs and specific approvals, 38 System institutions developed programs and became active in making investments that provided funding for rural development projects in rural communities and capital to rural entrepreneurs. These investments have resulted in successful projects helping rural communities provide essential community facilities, infrastructure, and services to rural residents. The farmers, ranchers, and agricultural producers of the FCS are dependent on rural communities for off-farm income and services. This proposed rule will enable the System to partner with rural development authorities and other non-System lenders to address rural community needs and improve the quality of life for farm families and rural residents.

<u>Significant Components of the Proposal</u>: The significant components of proposed § 615.5176 are:

Rural Area Defined–proposed § 615.5176 (a) authorizes System banks, associations, and service corporations to make rural community investments only in areas <u>outside</u> of an "urbanized area" as defined by the United States Census Bureau. As a result, the proposed rule would authorize System institutions to make these investments in areas that have a population of fewer than 50,000 residents, based on the latest decennial census of the United States.

Debt Securities–proposed § 615.5176 (b) authorizes System institutions to purchase debt securities that provide financing for:

(1) Essential community facilities such as hospitals, health care facilities, emergency services, and schools,
(2) Basic transportation infrastructure such as roads, bridges, and other public transportation systems,
(3) Revitalization of rural communities after a disaster and where an emergency has been declared pursuant to law,
(4) Rural development projects guaranteed or sponsored by the United States, any state, the Commonwealth of Puerto Rico, local or municipal governments, or any other political subdivision, or
(5) Non-System financial institutions to fund rural development.

The proposed rule defines debt securities as obligations that are commonly recognized in capital markets as a medium for investments, including government obligations, corporate bonds, revenue bonds, asset-backed securities, and mortgage securities. The proposed rule expressly excludes commercial loans and instruments or transactions that are more similar to commercial loans than to traditional investment instruments in order to clarify the statutory distinction between loans and investments.

Equity Investments–proposed § 615.5176 (c) authorizes FCS institutions to make equity investments in rural business investment companies and venture capital funds that support start-up rural enterprises and imposes limits that ensures System institutions hold these investments as only passive investments.

Process to Permit "Other" Investments–proposed § 615.5176 (d) allows the FCA to approve written requests from FCS institutions to hold investments not expressly authorized by the proposed rule for investments that do not currently exist, but may emerge in future financial markets.

Restrictions–proposed § 615.5176 (e) establishes the following restrictions on System investments in rural communities: (1) An overall portfolio limit on rural community investments of 150 percent of the total surplus of each FCA institution, (2) an obligor limit for rural community investments of 15 percent of total surplus, (3) a maturity of 20 years and in the event the majority of the investment is guaranteed, a maturity of 40 years is permitted, (4) exclusion of rural community investments from bank liquidity reserves, (5) review of association investments by its funding bank in accordance with statutory requirements, and (6) the attribution of service corporation investments to entities that own the service corporation.

Management of Investments–proposed § 615.5176 (f) addresses responsibilities for FCS boards of directors, minimum requirements for investment policies, and prudent investment practices.

The staff believes the proposed rule provides the flexibility to meet the needs of rural communities. The proposed rule also establishes adequate controls and parameters to ensure investments in rural communities do not adversely affect the safety and soundness of FCS institutions or cause the System to move away from its primary mission of lending to agriculture, agricultural businesses, and rural utilities.

Legal Authority:
Sections 1.5(15) and 3.1(13)(A) of the Act authorize Farm Credit banks to invest in securities of the United States and its agencies, and to make "other investments as may be authorized under regulations issued by the Farm Credit Administration." Similarly, sections 2.2(10) and 2.12(18) of the Act authorize FCS associations to invest their funds as approved by their district banks in accordance with FCA regulations. Service corporations are authorized by section 4.25 of the Act to engage in investment activities to the same extent as their System parents. Additionally, the preamble to the Act states that Congress enacted the statute "to provide for an adequate and flexible flow of money into rural areas." The preamble and investment provisions of the Act form a broad statutory framework that confers considerable discretion on the FCA to decide the purposes, conditions, and limits for all System investment activities. Since 1971, the FCA has exercised its authority under these statutory provisions to enact regulations that permit System institutions to invest in America's rural communities. Currently, FCA regulations authorize System institutions to hold the following investments in agriculture or rural communities: (1) farmers' notes; (2) obligations of state, local, or municipal governments; (3) Farmer Mac mortgage securities; and (4) asset-backed securities that are collateralized by loans on agricultural equipment. System institutions may also hold other investments that the FCA approves on a case-by-case basis under § 615.5140(e). Since 2005, System institutions have made investments in rural communities under pilot programs that the FCA has approved on a case-by-case basis. Based on the positive experience of these pilot programs, staff recommends that the FCA propose a rule that would allow all System institutions to make certain investments in rural communities under prescribed conditions without prior FCA approval.

Possible Opposing Comments:
The staff expects the American Bankers Association, the Independent Community Bankers of America and commercial bankers to challenge the legality of the proposed rule. Commercial bankers and their lobbies have claimed that the FCA has authority under the Act only to approve investments that enable System institutions to maintain liquidity and manage financial risks to their balance sheets. The plain language of the Act expressly authorizes System institutions to hold any investment that the FCA approves. Under this statutory framework, the FCA has broad discretion to allow System institutions to make investments in America's rural communities under conditions that the Agency prescribes. The staff also expects commercial banks to claim that the proposed rule enables System institutions to evade restrictions on their lending powers by classifying loans to ineligible borrowers as investments. The proposed rule addresses this issue by expressly defining securities as "obligations that are commonly recognized in the established capital markets as a medium for investment." The proposed rule also states that "securities exclude commercial loans and any instrument or transaction that is more similar to a commercial loan than to a traditional investment instrument or transaction." Finally, besides these broad challenges, the staff also anticipates that the System's competitors may try to make technical legal challenges to specific provisions of the proposed rule, such as

rural community size, portfolio limits (which could potentially cause loans to farmers, ranchers, and cooperatives to comprise less than 50 percent of an association's total assets), and venture capital funds.

Attachment