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FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC70

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Risk-Based Capital Stress Test, Version 5.0

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: In this advance notice of proposed rulemaking (ANPRM), the Farm Credit Administration (FCA, we, us, our) is requesting comments on alternatives to using credit ratings issued by nationally recognized statistical ratings organizations (NRSRO or credit rating agency) in regulations addressing the Risk-Based Capital Stress Test (RBCST or stress test) for the Federal Agricultural Mortgage Corporation (Farmer Mac or FAMC). Recent legislation requires every Federal agency to remove any references to credit ratings from its regulations and to substitute them with other standards of creditworthiness considered appropriate. Additionally, in response to this same legislative emphasis on ensuring appropriate prudential oversight of derivatives transactions, we are considering whether the RBCST should include a more explicit and comprehensive capital charge for counterparty risk stemming from derivative transactions. Lastly, through the ANPRM we are seeking public input on how we might revise the operational and strategic business planning requirements for FAMC to place greater emphasis on diversity and inclusion.

DATES: You may send comments on or before August 15, 2011.

ADDRESSES: We offer a variety of methods for you to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we no longer accept comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters", then "Public Comments", and follow the directions for "Submitting a Comment".
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Laurie A. Rea, Director, Office of Secondary Market Oversight, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters", then "Public Comments", and follow the directions for "Reading Submitted Public Comments". We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434,

Or

Laura McFarland, Senior Counsel, Office of the General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The purpose of this ANPRM is to gather public input on how FCA might:

- Revise existing Farmer Mac RBCST regulations to replace data from credit rating agencies.
- Comprehensively address derivative counterparty exposure in the RBCST; and
- Revise operational and strategic business planning requirements to place greater emphasis on diversity and inclusion.

II. Background

Farmer Mac is an institution of the Farm Credit System, regulated by FCA through the FCA Office of Secondary Market Oversight (OSMO). Farmer Mac was established and chartered by Congress to create a secondary market for agricultural real estate mortgage loans, rural housing mortgage loans, and rural utilities loans, and it is a stockholder-owned instrumentality of the United States. Title VIII of the Farm Credit Act of 1971, as amended, (Act) governs Farmer Mac.[1]

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) was enacted.[2] Section 939A of the Dodd-Frank Act requires Federal agencies to review all regulatory references to NRSRO credit ratings and replace those references with other appropriate standards for determining creditworthiness. The Dodd-Frank Act further provides that, to the extent feasible, agencies should adopt a uniform standard of creditworthiness for use in regulations, taking into account the entities regulated and the purposes for which such regulated entities would rely on the creditworthiness standard.

The FCA uses credit rating agency data in its RBCST regulations for Farmer Mac. Section 8.32 of the Act required FCA to establish a risk-based capital stress test for Farmer Mac's portfolio.[3] This stress test determines the level of regulatory capital necessary for Farmer Mac to maintain positive capital during a 10-year period where stressful credit and interest rate conditions occur. We first published regulations on the stress test, and other requirements related to section 8.32 of the Act, in the Federal Register at 66 FR 19048 (April 12, 2001). Since then, we revised the stress test several times, most recently to capture capital requirements for Farmer Mac's rural utilities authorities. The existing RBCST for Farmer Mac is contained in 12 CFR part 652, subpart B, and it currently relies, in part, on NRSRO credit ratings when calculating regulatory minimum capital requirements.

We have comprehensively reviewed our regulations that use or rely on credit ratings, including other sections in part 652 which govern Farmer Mac's non-program investments and liquidity reserve requirements. This ANPRM is one of several notices and proposed rules on which we will be seeking public input relating to use of credit ratings in our rules.

A. Farmer Mac Programs

Under the Farmer Mac I program, FAMC guarantees prompt payment of principal and interest on securities representing interests in, or obligations backed by, mortgage loans secured by first liens on agricultural real estate or rural housing. It also purchases, or commits to purchase, qualified loans or securities backed by qualified loans directly from lenders. Under the Farmer Mac II program, FAMC purchases and securitizes portions of certain loans guaranteed by the U.S. Department of Agriculture, including farm ownership and operating loans and rural business and community development loans. Farmer Mac also guarantees the timely payment of principal and interest on the securities created from these loans. In 2008, Congress granted Farmer Mac the authority to purchase and guarantee securities backed by loans to rural electric and telephone utility cooperatives as program business.[4] Farmer Mac also provides a secondary market for USDA-guaranteed farm program and rural development loans.

B. Risk-based Capital and Credit Ratings

Under our rules, Farmer Mac's regulatory capital must be sufficient so that it would remain positive during the 10-year time horizon of the stress test. One component of the RBCST accounts for the risk of loss on specific types of program investments (i.e., investments backed by agricultural real estate mortgage loans, rural housing loans, or rural utility cooperative loans) that include credit enhancement features. In this context, credit risk is adjusted downward based on the whole-letter credit rating of the counterparty on AgVantage and similarly structured assets. The adjustment is made to recognize the risk-reducing strength of the counterparty's general obligation backing of these securities. These securities are further backed by eligible loan collateral.

Another component of the RBCST estimates counterparty risk associated with non-program investments, e.g., corporate debt, asset-backed securities and mortgage- related securities. In this context, the RBCST reduces earnings at rates related to the cumulative historical default and recovery rates of corporate debt by whole-letter credit rating category as published by Moody's Investor Services.[5] The RBCST's calculations in each of these two components use five whole-letter rating categories. It then assigns counterparties into these categories by referencing ratings issued by an NRSRO for the counterparty. The regulations, in turn, specify the change in expected cash flows during the stress period to reflect the risk of default by a counterparty based in part on the assigned ratings category. The changes in cash flows decrease projected losses on program assets and decrease earnings on non-program investments, which then translate to changes in equity over the modeling horizon and affect the required minimum regulatory capital calculated by the stress test.

FCA initially chose to use NRSRO ratings in the RBCST as a source of objective and neutral third-party assessments of the credit risk for particular instruments and counterparties. We used ratings because they were readily and publicly available. The use of NRSRO ratings was also, at the time, believed to offer enhanced consistency in credit evaluation across different components of the RBCST. In 2010, the Dodd-Frank Act addressed, in part, the structure of credit rating agencies, requiring revisions and imposing other requirements in an effort to resolve the conflicts of interest and other difficulties believed to be at the center of the 2008-2009 financial market crisis. The Dodd-Frank Act also questioned the value of these ratings when used as the primary data source in the assessment of the creditworthiness of a security or money market instrument. In connection with that, the Dodd-Frank Act requires every Federal agency to remove any reference to, or reliance on, credit rating agencies in its regulations and replace any such reference with an alternative standard of credit worthiness considered appropriate for the regulatory purpose. As a result, we are seeking suggestions on what alternative data sources would be most appropriate for the RBCST.

C. Considerations and Objectives for a New Approach to Quantifying Relative Creditworthiness

FCA believes that any new standard of creditworthiness should distinguish between different levels of credit risk, in an accurate and timely manner, and be transparent in its approach. We believe it should also be applied consistently across the multiple components of the RBCST and be reasonably simple, while not unduly burdensome to apply and not be easily subject to manipulation. FCA recognizes that any resulting system will likely involve trade-offs among these objectives, e.g., simple versus accurate and timely, accurate and timely versus not burdensome to apply.

To eliminate the use of NRSRO ratings in calculating risk-based capital requirements for Farmer Mac, we need to develop an alternative basis to assess counterparty risk. One approach may be to identify objective criteria that Farmer Mac could apply to categorize credit exposures into different risk classes and assess counterparty risk accordingly. The criteria may be broadly designated. For example, credit exposures could be divided into government and non-government, secured and unsecured, or other categories, such as maturity. Such a broad approach, however, may not be able to sufficiently and consistently account for difference in relative risk among exposures that fall into the same category. FCA may also consider adopting criteria that reference certain financial or other metrics related to the obligor or counterparty. To be meaningful, the criteria would need to account for or bear a reasonable correlation to the potential riskiness of default among different obligors or counterparties. Any criteria would also need to be readily obtainable for all relevant counterparties by FCA, Farmer Mac and the public or it might not be sufficiently transparent and objective. The standards would need to ensure that the investment or position is not speculative, and carries credit risk appropriate for Farmer Mac's risk profile and the authorized purposes for non-program investments. As any new counterparty risk evaluation approach is initiated, there is the potential for increased risk as the new system is implemented.

FCA might also consider an approach that builds on Farmer Mac's internal credit review process and allows it to assign risk ratings to various categories and assess risk based on qualitative and quantitative standards set by FCA regulations. For example, FCA could assign loss rate estimates based on Farmer Mac's internal ratings or some modification of such, as reviewed or approved by FCA – or simply review or approve Farmer Mac's mapping of its assigned risk ratings to estimated loss rates. This approach would be more subjective than the alternative discussed above but could allow FCA to leverage the data collection and analysis already performed by Farmer Mac. Under this approach, FCA would likely rely heavily on the supervisory process to make sure that Farmer Mac is strictly following its internal guidelines and not assuming high levels of credit risk.

Questions (1) through (11) of Section III of this ANPRM address this topic.

D. Counterparty Risk on Derivatives

As part of our Dodd-Frank Act review and the increasing emphasis by the financial industry on ensuring appropriate prudential oversight of derivatives transactions, we are also considering whether the RBCST should include a more explicit and comprehensive capital charge for counterparty risk stemming from derivative transactions.

The RBCST produces a single comprehensive capital requirement for Farmer Mac by modeling changes in cash flows under a specific statutory stress scenario. We believe there may be opportunities to revise the RBCST to add a representation of counterparty default exposure on derivatives transactions by considering both net replacement cost as well as current exposure to individual cash flows based on an assessment of the counterparty's creditworthiness.

Questions (12) and (13) of Section III. of this ANPRM address this topic.

E. Capital and Business Planning

As part of this ANPRM, we are seeking input on how we might revise § 652.60(b) on operational and strategic business planning requirements to place greater emphasis on diversity and inclusion in both Farmer Mac's personnel as well as the borrowers and lenders who benefit from its secondary market activities.

We believe an integral part of promoting and achieving inclusion and diversity can be accomplished through an effective operational plan that includes strategies to seek out qualified loans from a diverse group of sources and provides rural lenders with financing products that serve a diverse array of borrowers, such as small, beginning, new, disabled, female, and minority farmers, ranchers, and rural homeowners, as well as cooperatives with diversity of ownership. We believe promotion of inclusion and diversity should also extend to non-traditional agricultural producers, such as local food systems, organic or specialty crop farmers, and community-supported agriculture.

Additionally, we are considering whether Farmer Mac's operational and strategic plans should include strategies and actions to achieve diversity and inclusion within FAMC's workforce, management, and governance structure, as well as an assessment of the progress FAMC has made in this area. We are also contemplating whether the plans should describe FAMC's succession programs.

Questions (14) and (15) of Section III. of this ANPRM address this topic.

III. Request for Comments

FCA regulations governing the Farmer Mac RBCST contain specific references to credit ratings issued by NRSROs for purposes of calculating regulatory minimum capital requirements. FCA is issuing this ANPRM to identify standards that may be appropriate replacements for credit ratings issued by NRSROs, which maintain compliance with statutory design requirements for the RBCST. Other regulatory agencies have also issued ANPRMs as part of their process to address references to credit ratings in their capital regulations and prudential standards.[6] We encourage any interested person(s) to submit comments on the following questions and ask that you support your comments with relevant data or examples. We remind commenters that comments and data submitted in support of a comment are available to the public through our rulemaking files.

1. What core principles would be most important in FCA's development of new standards of creditworthiness?

2. What qualitative and quantitative standards would FCA need to set to implement an approach that relied on the Farmer Mac to generate internal estimates of counterparty risk exposures? What are the strengths and weaknesses of such an approach?

3. Is it important that FCA's approach to replacing its reliance on credit rating agency data be consistent with that of other financial regulators or with those of other Farm Credit System institutions? If so, how important and why?

4. What specific creditworthiness or investment criteria should FCA use in its RBCST regulation?

5. What types of objective criteria should be used to differentiate credit exposures and apply meaningful counterparty risk estimates in the RBCST?

6. Should different criteria be used for different broad classes of investments or exposures? If so, what perverse incentives or other unintended consequences could that lead to? For example, could criteria that are perceived to be more flexible or subjective for a given asset class incent the regulated entity to accept a proportion of exposure to that asset class relative to its entire program (or non-program) portfolio that it might deem excessive without that incentive?

7. What approach would estimate a meaningful and consistent level of counterparty risk for a variety of exposures by employing publicly available qualitative and quantitative metrics, such as individual obligor credit spreads and/or financial ratio analysis to estimate probability of default and recovery rates?

8. Alternatively, could such estimates be reasonably made at the level of the market (e.g., identifying an index of industry sector spreads and stratifying spreads into certain ranges) and mapped to loss rates set by FCA?

9. How might a set of loss rates be developed for each spread stratum?

10. Are there any existing objective tools or approaches that could readily replace references to ratings issued by NRSROs in the RBCST?

11. What other approaches or methodologies not discussed above should FCA consider?

12. What methodologies or approaches should FCA consider to more explicitly incorporate a derivatives counterparty exposure charge into the RBCST?

13. What is the best manner of evaluating minimum capital requirements on derivative counterparty exposures in the RBCST and should a pre-processing model be constructed (i.e., a sub-model used to derive inputs into the RBCST) to represent this risk--both in terms of missed individual contractual cash flows as well the replacement cost on defaulted derivatives? If so, how should replacement costs be estimated?

14. Should Farmer Mac be required to include strategies in its marketing plans that address how its secondary market programs and products will be offered to all qualified borrowers, including:

(a) Minorities, the disabled, and women;

(b) Young, beginning, small, and family farms and cooperatives; or

(c) Non-traditional agricultural producers, such as local food systems, organic or specialty crop farmers and the lenders who serve them? Why or why not?

15. Should Farmer Mac's marketing plans set quantitative goals to increase purchases of, or commitments to purchase, loans to young, beginning, small, and family farms, and those owned or operated by minorities, the disabled, and women? If so, what would be the best method to apply such goals to rural utility cooperatives (e.g., minority-managed cooperatives or cooperatives that serve predominantly minority residential customers or minority-owned commercial customers)?

16. To what extent should FCA regulations require Farmer Mac to develop a human capital plan as part of its strategic and operational business plan to foster diversity in its workforce and succession planning?

Dated: June 10, 2011

Mary Alice Donner,
Acting Secretary,
Farm Credit Administration Board.

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[1] Pub. L. 92-181, 85 Stat. 583, 12 U.S.C. 2001 et seq. (December 10, 1971).

[2] Pub. L. 111-203, 124 Stat. 1376, (H.R. 4173), July 21, 2010.

[3] 12 U.S.C. 2279bb-1.

[4] Section 5406 of Pub. L. 110-246, 122 Stat. 1651 (June 18, 2008)(repealing and replacing Pub. L. 110-234).

[5] Emery K., Ou S., Tennant, J., Kim F., Cantor R., "Corporate Default and Recovery Rates, 1920 – 2009," published by Moody's Investors Service, February 2010.

[6] See 75 FR 49423 (Aug. 13, 2010), 75 FR 52283 (Aug. 25, 2010), and 76 FR 5292 (Jan. 31, 2011).