

**76 FR 53344, 08/26/2011**

**Handbook Mailing HM-11-10**

[6705-01-P]

**FARM CREDIT ADMINISTRATION**

**12 CFR Part 615**

RIN 3052-AC71

**Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Capital Adequacy Risk-Weighting Revisions: Alternatives to Credit Ratings**

**AGENCY:** Farm Credit Administration.

**ACTION:** Advance notice of proposed rulemaking.

**SUMMARY:** Farm Credit Administration (FCA or Agency) regulations on the capital adequacy of Farm Credit System (FCS or System) institutions include various references to and requirements of reliance on credit ratings of a security or money-market instrument. Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or DFA), enacted on July 21, 2010, requires Federal agencies to remove any reference to or requirement of reliance upon such credit ratings, and substitute in their place standards of creditworthiness that they deem appropriate for such regulations. The FCA seeks public comment on alternatives to the use of credit ratings in these regulations.

**DATES:** You may send comments on or before November 25, 2011.

**ADDRESSES:** There are several methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting 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](mailto: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 E-Rulemaking Web site: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- Mail: Send mail to Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of 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, 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:**

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#### **I. Background**

The FCA has promulgated its capital standards in 12 CFR Part 615 of its regulations. These regulations contain references to and regulatory requirements premised on the use of credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs).<sup>1</sup> Section 939A of the DFA requires each Federal agency to review “(1) any regulation issued by such agency that requires the use of an assessment of the creditworthiness of a security or money market instrument; and (2) any references to or requirements in such regulations regarding credit ratings.” After such review, each agency must then “modify any such regulation identified by the review . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate for such regulations.”<sup>2</sup>

The FCA is seeking comments on how to revise our capital standards to comply with this requirement of Dodd-Frank.

#### **II. FCA’s Risk-Based Capital Standards**

The FCA’s rules for risk-weighting capital are set forth in §§ 615.5210-615.5212. Section 615.5210 describes the capital treatment of certain securitizations. Sections 615.5211 and 615.5212 describe the capital treatment of on- and off-balance-sheet assets.

FCA first adopted risk-weighting<sup>3</sup> categories for System assets as part of the 1988 capital adequacy regulations required by the Agricultural Credit Act of 1987. FCA adopted many elements of the 1988 Basel Accord in its risk-based capital rules. For instance, the placement of assets in risk-weight categories depends, in part, on NRSRO ratings.

In 1997,<sup>4</sup> 1998,<sup>5</sup> and 2005,<sup>6</sup> the FCA adopted further revisions to its risk-based capital regulations. The 1997 revisions to our capital regulations added new standards for System banks and associations, a collateral ratio for System banks, and procedures for setting higher capital standards for individual institutions and for issuing capital directives. Revisions in 1998 addressed risk-weighting and other issues. Revisions to the capital standards in 2005 implemented a ratings-based approach (RBA) for risk-weighting investments in recourse obligations, residual interests (other than credit-enhancing interest-only strips), direct credit substitutes, and asset- and mortgage-backed securities.<sup>7</sup> Under the

RBA, the risk weighting of such assets increases as the credit rating declines.

The FCA seeks to ensure that the regulatory capital framework applied to System institutions is broadly consistent with those of other Federal financial regulators (OFFRs). In addition to the rulemakings noted above, the FCA issued several Advance Notices of Proposed Rulemaking (ANPRMs) beginning in 2007 seeking comment on issues associated with adopting the standardized version of Basel II.<sup>8</sup> As OFFRs revise their regulatory capital rules in order to implement Basel III, the FCA intends to revise its rules accordingly.

### **III. Request for Comment**

#### **A. Creditworthiness Standards**

In response to the mandate in Section 939A of Dodd-Frank, we are considering alternative standards of creditworthiness. Alternative standards could be developed by the regulator, the regulated entity, or some third party that is not an NRSRO. In practice, all three groups may play a role. We seek comments on the roles best played by each party. To be effective, creditworthiness standards should be based on readily available objective data and calculated using transparent methodologies and assumptions. In addition, effective creditworthiness standards should lead diverse raters to assign similar assets to similar risk categories.

In evaluating any standard of creditworthiness, we will seek, to the extent practical, and consistent with other objectives, to follow these principles:

- Foster prudent risk management by System institutions;
- Ensure that creditworthiness standards for securities and money-market instruments are consistent across all types of financial institutions and over time;
- Be transparent;
- Appropriately distinguish the credit risk associated with a particular exposure within an asset class;
- Provide for the timely and accurate measurement of changes in creditworthiness or investment quality over time;
- Allow for adequate supervisory review; and
- Be cost-efficient and strike an appropriate balance between the benefits resulting from increased accuracy of credit risk assessments and the costs of implementation.

**Question 1:** The FCA seeks comment on the principles that should guide the Agency's formulation of creditworthiness standards. What core principles would be most important and appropriate in FCA's development of new standards of creditworthiness? Do the principles delineated above capture the appropriate elements of sound creditworthiness standards? How could such principles be strengthened?

**Question 2:** How can we assure ratings consistency over time, across System institutions, and maintain consistency with the ratings of similar assets by commercial banks and other capital market

participants? Should the creditworthiness standards developed for regulatory capital purposes be the same as those developed for regulation of the investment management or liquidity activities of FCS institutions?

## **B. Alignment of Creditworthiness Standards with the Other Federal Financial Regulators**

In response to the mandate of section 939A of Dodd-Frank, OFFRs have issued ANPRMs or proposed rulemakings seeking comment on credit-rating alternatives. 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 issued a joint ANPRM in August 2010.<sup>9</sup> The National Credit Union Administration (NCUA) issued a Notice of Proposed Rulemaking in March 2011.<sup>10</sup> The Federal Housing Finance Agency (FHFA) issued an ANPRM in January 2011.<sup>11</sup>

**Question 3:** Should the FCA seek to be consistent with the standards of creditworthiness developed by OFFRs?

## **C. Assignment of Risk Weights**

One way to eliminate references to credit ratings in our capital regulations would be to assign risk weights using broad measures of creditworthiness. For example, our current regulations assign risk weights to certain sovereign and bank exposures according to whether or not the sovereign is a member of the Organization for Economic Cooperation and Development. This approach is simple to apply but provides little distinction among risks in this asset class.

Alternatively, we could assign risk weights using more specific measures. For example, we could assign risk weights using defined benchmark securities, such as comparable maturity U.S. Treasury securities, or using obligor-specific financial data such as debt-to-equity ratios. This approach could be more risk-sensitive but also require more effort.

**Question 4:** We seek comments on the benefits and drawbacks of assigning assets to risk-weighting categories based broadly on the type of obligor (such as sovereign, agency, municipal, or corporate), or based more specifically on characteristics of the instrument itself (such as collateral, tenor, spread to a benchmark, or some other evidence of marketability).

We must also eliminate use of credit ratings in our capital regulations for securitization exposures. One approach might be to require dollar-for-dollar capital on any exposure that does not meet stringent criteria for collateralization and marketability. For example, we could assign a risk weight to a senior-most tranche but require dollar-for-dollar capital for all other tranches in that security. Other approaches suggested by OFFRs would use some type of “gross up” treatment or other specific criteria to determine the risk weight of the exposure.<sup>12</sup>

**Question 5:** How should the FCA risk-weight structured securities, derivatives, and other exposures such as recourse obligations, direct credit substitutes and residual interests?

## **D. Internal Ratings-Based Models and the Use of Third Parties**

One way to eliminate reliance on NRSRO ratings would be to require FCS institutions to develop internal risk exposure methodologies for making creditworthiness determinations for certain exposures. In some cases, FCS institutions may need to contract with third parties to obtain quantitative data, such as probabilities of default, as part of their internal process for making such determinations. Also, FCS

institutions could continue to use the opinions of external experts as an element in assessing creditworthiness. Regardless of the approach we adopt, we would establish criteria to ensure that the methodology employed is consistent with safe and sound banking practices.

**Question 6:** Should each System bank be required to develop its own risk exposure methodology? Should each association be required to develop its own risk exposure methodology? If so, how should the FCA assure consistency across the individual methodologies? How would the FCS prepare its quarterly and annual reports to investors? Should System banks be required to develop a common risk exposure methodology?

**Question 7:** Are there certain types of assets that would require the use of a third party to provide data to FCS institutions as part of their internal process for making creditworthiness determinations? How could the use of third-party service providers be implemented to ensure quality, transparency, and consistency? What role should third-party assessors be allowed to play in determining creditworthiness? We seek comments on the roles best played by each party.

#### **E. Burden**

Developing alternative measures of creditworthiness will likely require significant initial and ongoing costs. Accordingly, we are seeking comment on the burden — both financial and operational — that various alternative approaches to developing such standards might entail.

**Date: August 18, 2011**

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

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<sup>1</sup>An NRSRO is an entity registered with the U.S. Securities and Exchange Commission (SEC) under section 15E of the Securities and Exchange Act of 1934.

<sup>2</sup>See section 939A, Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010).

<sup>3</sup>We use risk weightings to compute the risk-adjusted asset base for System banks and associations. This base is then used to calculate certain regulatory capital ratios. These regulations are in 12 CFR Part 615, Subparts H and K.

<sup>4</sup>See 62 FR 4429 (Jan. 30, 1997).

<sup>5</sup>See 63 FR 39219 (Jul. 22, 1998).

<sup>6</sup>See 70 FR 35336 (Jun. 17, 2005).

<sup>7</sup>For the RBA in the final rule, we took the approach that highly rated positions would receive a favorable risk weighting – which we characterized as being less than 100 percent.

<sup>8</sup>See 72 FR 34191 (Jun. 21, 2007), 72 FR 61568 (Oct. 31, 2007), 75 FR 39392 (Jul. 8, 2010).

<sup>9</sup>See 75 FR 52283 (Aug. 25, 2010).

<sup>10</sup>See 76 FR 11164 (Mar. 1, 2011).

<sup>11</sup>See 76 FR 5292 (Jan. 31, 2011).

<sup>12</sup>See 75 FR 52283 (Aug. 25, 2010).