

# ***Frequently Asked Questions? (FAQs)***

## ***Similar Entity Reporting***

On October 24, 2006, Doug Valcour, Deputy Director, Office of Management Services, sent out to all Farm Credit System (FCS or System) institutions revisions that clarify the reporting requirements for similar entity transactions on Call Report *Schedule RC-O – Asset Purchases and Sales*. The purpose of these FAQs is to provide some additional information about these revisions.

### **1. Why was there a need to revise Call Report instructions for Schedule RC-O?**

Several System institutions raised questions concerning the reporting of credits that enter the System as transactions to borrowers who are similar entities under one title of the Farm Credit Act of 1971, as amended (Act), but are eligible borrowers under other titles. Many similar entity transactions enter the System through an institution that operates under one title of the Act, which then sells participations in the credit to other System institutions that operate under different titles of the Act (cross-title).<sup>1</sup> The borrower may be either an eligible borrower or a similar entity for the System institution(s) that buys participations in these credits. The old call reporting instructions were based on the concept of “once a similar entity, always a similar entity” and, therefore, they required all System banks and associations to report these credits as similar entity transactions, even if the borrower was eligible for credit from the institution(s) that bought the loan participations. The FCA has determined that a System institution that buys participations in credits to borrowers who are eligible under its title lending authorities should no longer report these credits as similar entity transactions.

### **2. Please provide an example that will clarify the FCA's new position on this cross-title issue?**

Many similar entity transactions enter the System through CoBank, ACB (CoBank) under its title III authorities. CoBank subsequently sells participations in its portion of the credit through a *master participation agreement* to other System institutions that operate under title I and/or II of the Act. In many cases, the debtor is a similar entity for CoBank, but is an eligible borrower for FCBs and associations that buy participations in these credits. Under the revised call report instructions, CoBank would report its interest in the credit as a similar entity transaction, but the FCBs and associations would report their participation interests in the same credit as a transaction with an eligible borrower. As a result, the statutory restrictions on similar entity transactions would apply only to CoBank, and not the other System institutions that bought participations in the credit from CoBank.

Because the debtors are eligible borrowers for the System institution(s) that buys these participations, the new call report instructions mean that these transactions are treated the same as if these institutions had bought participations in the same

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<sup>1</sup> System institutions that purchase participations in these credits do not have a legal or contractual relationship with the borrower. However, the FCS lender that first brought the credit into the System under its similar entity authorities usually has a direct contractual relationship with the borrower. The FCA emphasizes that borrower rights, borrower stock, and territorial consent do not apply when a System institution buys traditional participations in loans to eligible borrowers because the purchaser does not have a direct legal or contractual relationship with the borrower.

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credit directly from non-System lenders. As a result, the reporting requirements for these participations will be consistent, regardless of whether an FCB or association bought them from CoBank or a non-System lender.

#### **3. What are the Call Reporting and regulatory requirements for borrowers who are similar entities under titles I, II, and III of the Act?**

When the borrower is a similar entity for all System banks and associations, all System institutions would report their interests in these credits as similar entity transactions. Additionally, all FCS institutions are subject to the statutory restrictions that apply to similar entity transactions.<sup>2</sup> Each System institution will report these transactions on Line Item 2(a) or 2(b) of Schedule RC-O.

#### **4. Is an eligible borrower for System associations a similar entity for FCBs that have downloaded their direct lending authorities?**

**No.** Section 4.18A(a)(2) of the Act defines a "similar entity" as a person who is not eligible for a loan from a Farm Credit Bank or association. Thus, a debtor who is a similar entity for a direct lender association is also a similar entity for an FCB. An FCB that has transferred its direct lending authority to its association(s) cannot lend directly to eligible borrowers. However, these FCBs may buy participations in loans to borrowers who are eligible under titles I, II, and III from other FCS institutions.

#### **5. Could a System institution buy an assignment in a credit to a debtor who is a similar entity under the title(s) of the Act which it operates?**

**Yes.** Section 3.1(11)(B)(iii) of the Act defines "participations"<sup>3</sup> for similar entities to include assignments. For this reason, System institutions could buy an assignment in a credit to a debtor who is a similar entity under its title authorities from either a (1) non-System lender, or (2) a System lender *if* the borrower is *also* a similar entity under its title of the Act. It would report its assignment on line 2(a) or 2(b) of Schedule RC-O.

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<sup>2</sup> The statutory restrictions on similar entity transactions are found in sections 3.1(11)(B)(i) and 4.18A(b) of the Act. Essentially, these two sections of the Act authorize FCS banks and associations to participate in credits to similar entities, subject to the following restrictions (1) participations to a single credit risk cannot exceed 10 percent (or a higher percentage set by FCA regulations and approved by the institution's shareholders) of total capital, (2) System institutions, either individually or collectively, must always hold less than 50 percent of the principal amount of the credit, and (3) similar entity participations cannot exceed 15 percent of the institution's total assets. Additionally, section 4.18A(b)(4) of the Act provides that loans to rural residents for rural housing financing cannot qualify as similar entity credits.

<sup>3</sup> Section 3.1(11)(B)(iii) of the Act establishes a special definition of "participate" and "participation" that applies only to similar entity loans. According to this section of the Act, these two terms mean "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."

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- 6. Suppose a borrower is a similar entity for the FCS institution that brings the credit into the System, but is an eligible borrower for other System institutions. Could these System institutions buy assignments from the FCS institution that brought the credit into the System?**

Buying assignments under these circumstances would raise special issues for the FCA. Accordingly, System banks and associations should not buy assignments in these types of credit unless they first receive express written permission to do so from the FCA.<sup>4</sup>

- 7. Under the new reporting guidelines, the FCS could hold more than 50 percent of a credit to a borrower who is a similar entity under one title of the Act, but is an eligible borrower under the other title(s) of the Act. Under this scenario, would the System institution(s) that entered into the transaction under their similar entity authorities violate the provision of the Act that prohibits the System from collectively holding 50 percent or more of the principal amount of a similar entity credit?**

**No.** This statutory restriction applies only when the borrower is a similar entity for the System institution(s) that has an interest in the credit. The restriction does not apply when the debtor is an eligible borrower for the System institution(s) that buy traditional participations in the credit. Consequently, under this scenario, the System could hold more than 50 percent of the principal amount of the credit.

- 8. When will System institutions start reporting in accordance with this revised direction?**

Compliance with this change in the reporting instruction is mandatory starting March 31, 2007, but voluntary prior to that date. However, if an institution elects to use the new instructions prior to the implementation date, it must state so in an addendum to Schedule RC-O.

- 9. Do System institutions have to document eligibility on these transactions?**

**Yes.** The call report instructions require a System institution to support its reporting under Schedule RC-O, by documenting its determination of whether the debtor is an eligible borrower or a similar entity under its title lending authorities.

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<sup>4</sup> FCS banks and associations that have been accepted into the FCA's Syndication Study have been granted regulatory relief for the duration of the Study. The Syndication Study excludes similar entities.

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The following examples are to illustrate expectations for Regulatory compliance and reporting on similar entity transactions.

**Example 1:** *Syndicated loan to a borrower that is a similar entity for CoBank, and a similar entity for an association, where the association acquires an interest in the loan through a participation arrangement with CoBank.*

*Regulatory Compliance:* CoBank and the association participating with CoBank in the similar entity credit must comply with similar entity regulatory requirements (see § 613.3300). As such, CoBank and the System institution(s) participating in the loan must maintain less than 50 percent of the principal of the loan at all times.

*Reporting Requirement:* Both CoBank and the association would report their activity in Schedule RC-O lines 2(a) and 2(b).

**Example 2:** *Syndicated loan to a borrower that is a similar entity for CoBank, but an eligible borrower for an association, where CoBank and the association acquire an interest in the loan in the secondary market from a non-System lender.*

*Regulatory Compliance:* CoBank must comply with similar entity regulatory requirements (see § 613.3300) when it purchases an interest in the credit. Associations can only acquire an interest in the credit under their participation authorities and, therefore, must comply with regulatory loan participation requirements found in Part 614 (see response to Question #6). Under this scenario, the System could end up holding more than 50 percent of the credit given the commercial bank is the selling entity. In this instance, when an association purchases an interest via a participation agreement with a commercial bank, the commercial bank retains the direct legal relationship with the borrower despite effectively transferring the credit risk to the association.

*Reporting Requirement:* CoBank would report its activity in Schedule RC-O line 2(a). Associations would report its activity on line 1(a).

**Example 3:** *Syndicated loan to a borrower that is a similar entity for CoBank, but an eligible borrower for an association, where the association acquires an interest in the loan through a participation arrangement with CoBank.*

*Regulatory Compliance:* CoBank must comply with similar entity regulatory requirements (see § 613.3300). The association must comply with regulatory loan participation requirements found in Part 614. If CoBank sells participations in the similar entity loan to an association, CoBank must comply with similar entity regulatory requirement on a gross, and not a net, credit exposure basis given CoBank maintains a direct legal relationship with the similar entity borrower despite the participation. Under this scenario, the System usually would not end up holding more than 50 percent of the credit since CoBank is the participation conduit to other System institutions. However, nothing would limit an association from participating with a non-System lender in this credit.

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*Reporting Requirement:* CoBank would report its activity in Schedule RC-O lines 2(a) and 2(b). Associations would report its activity on line 1(a).

**Example 4:** *Syndicated loan to a borrower that is a similar entity for CoBank, where a non-System lender acquires an interest in the loan through an assignment from CoBank.*

*Regulatory Compliance:* CoBank could then net out the portion sold to the non-System lender and purchase additional similar entity exposure as long as it complied with similar entity regulatory requirements. Under this scenario, CoBank could never end up holding more than 50 percent of the similar entity credit.

*Reporting Requirement:* CoBank would report its activity in Schedule RC-O lines 2(a) and 2(b).