FARM CREDIT SYSTEM INSURANCE CORPORATION
PREAMBLE TO POLICY STATEMENT ON THE SECURE BASE AMOUNT AND ALLOCATED INSURANCE RESERVE ACCOUNTS

SUMMARY: The Farm Credit System Insurance Corporation (Corporation) is publishing in final a Policy Statement on the Secure Base Amount and Allocated Insurance Reserve Accounts (AIRAs). This Policy Statement establishes a framework for the periodic determination of the Farm Credit Insurance Fund's (Insurance Fund) secure base amount.   It also implements the Corporation's authority to allocate excess Insurance Fund balances above the secure base amount into an account for each insured Farm Credit System Bank and one for the Farm Credit System Financial Assistance Corporation (FAC) stockholders.

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SUPPLEMENTARY INFORMATION: In 1987, Congress directed the Corporation to build and manage the Insurance Fund to achieve and maintain the secure base amount (SBA). For insurance premium purposes, the statute defines the SBA as 2 percent of the aggregate outstanding insured obligations of all insured banks (excluding a percentage of state and Federally guaranteed loans) or such other percentage of the aggregate amount as the Corporation in its sole discretion determines is "actuarially sound." (12 U.S.C. § 2277a-4(c)).

The Board reviews premiums at least semiannually to determine whether to adjust assessments in response to changing conditions. The statute specifies a limited form of risk-based premium assessments: 25 basis points for nonaccrual loans; 15 basis points for loans in accrual status (excluding certain state and Federally guaranteed loans); and a very modest premium for government-guaranteed loans. (12 U.S.C. § 2277a-4(a)). This formula was designed as an incentive for the Farm Credit System to make quality loans and at the same time build the Insurance Fund to a level that Congress believed would make a default on System debt obligations less likely.

In the Farm Credit System Reform Act of 1996, Congress gave the Corporation the discretion to reduce premium assessments before reaching the SBA. (12 U.S.C. § 2277a-4(a)). It also established a process for making partial distributions of excess funds in the Insurance Fund. (12 U.S.C. § 2277a-4(e)).

I. Secure Base Amount Determination

The law sets out a formula for determining the SBA: "2 percent of the aggregate outstanding insured obligations of all insured System banks." (12 U.S.C. § 2277a-4). It also allows the Corporation to choose another percentage, "as the Corporation in its sole discretion determines is actuarially sound to maintain in the Insurance Fund taking into account the risk of insuring outstanding insured obligations." Id. Thus far, the Corporation has used the statutory formula.

1. Accrued Interest

In the statute, an insured obligation is defined as "any note, bond, debenture, or other obligation" issued on behalf of an insured System bank under the appropriate subsection of section 4.2 of the Farm Credit Act (12 U.S.C. § 2277a). The proposed Policy Statement included both principal and accrued interest in the definition of "insured obligation" because section 5.52 of the Act established the Corporation to ensure the timely payment of principal and <u>interest</u> to investors. Also, it is commonly understood that an issuer of bonds or notes has an obligation to pay a debt, which includes interest, when due. Accordingly, to promote the safety and soundness of the System and add a safeguard for investors, the Board included "accrued interest" in the definition.

One commenter, commenting on behalf of System institutions, suggested that before including accrued interest in the definition, the Corporation should demonstrate that there is some actuarial reason for the secure base to be maintained at the higher level that will result from the inclusion of accrued interest. The Board disagrees with the commenter. The issue is a matter of statutory interpretation; it is not dependent upon an "actuarial" reason.

As noted, both principal and interest are insured. Thus, the "insured obligation" of FCSIC at a point in time is equal to both the principal and accrued interest at that point in time. The Policy Statement's inclusion of "accrued interest" in the definition of "insured obligation" for purposes of determining the SBA is consistent with the statute and its legislative history.

2. Maintaining the SBA

After calculating the insured obligations, the Corporation will apply the deductions specified in the statute for the government guaranteed portion of the System loans to determine the SBA. This calculation will be done at the end of each quarter. After the end of the calendar year, using the December 31 balances, the Corporation will decide whether the Insurance Fund exceeds the SBA. The Policy Statement uses the December 31 balances for this calculation because the statute, in the premium section, contemplates using a point in time method in this context (12 U.S.C. § 2277a-4(c)).

A commenter noted that the proposed Policy Statement and its preamble state the Corporation's commitment "to attain and maintain" the Fund at the SBA. The commenter suggested that this was a marked departure from the Policy Statement Concerning Adjustments to the Insurance Premiums and inconsistent with the statute. This contention is incorrect. The preamble to the Policy Statement Concerning Adjustments to the Insurance Premiums provides that FCSIC will attain and maintain the fund at the SBA. <u>See</u> 61 Fed. Reg. 39453. Thus, the new policy statement's requirement "to attain and maintain" the Fund is consistent with the earlier one on insurance premium adjustments.

More importantly, this Policy Statement is consistent with the law. Section 5.55 (b) directs the Corporation to reduce the premiums if the aggregate amounts in the Insurance Fund exceed the SBA. However, this same provision requires the Corporation to temper reductions so that premiums continue to be "sufficient to ensure that the aggregate of amounts in the Farm Credit Insurance Fund after such premiums are paid is not less than the secure base amount at such time"

(12 U.S.C. § 2277a-4(b)). This provision directs the Corporation to maintain the SBA, even after it reduces premiums.

The House Report on H.R. 3030 (H.Rep. 100-295), which in large part was adopted by the Conference Committee in 1987 when FCSIC was created, supports this interpretation. It states at page 61: " The fund would be maintained at 2 percent of the value of all System loans outstanding or such other level deemed appropriate by the board" (emphasis added). While Congress amended section 5.55 in 1996, granting FCSIC the discretion to reduce premiums before reaching the SBA, it did not alter the original mandate to reach the secure base amount and then maintain it at 2 percent.

In fact, when it added the AIRA accounts in 1996, Congress gave the Corporation "sole discretion" to eliminate or reduce the AIRA disbursements. Section 5.55 (e)(6)(B) provides for elimination or reduction of disbursements if circumstances "might require the use of the Farm Credit Insurance Fund" and "could cause the amount in the Farm Credit Insurance Fund during the calendar year to be less than the secure base amount" (12 U.S.C. § 2277a-4(e)(6)(B)). This provision demonstrates continued congressional intent to have the Corporation manage the Insurance Fund, including the new AIRAs, by maintaining the integrity of the SBA.

II. Allocated Insurance Reserve Accounts

1. Determining Whether There Are Excess Funds to Allocate to the AIRAs

The Farm Credit System Reform Act of 1996 established a process for making partial distributions of the Insurance Fund's balance above the SBA. It established in the Insurance Fund an AIRA for the benefit of each insured System bank and one for the FAC stockholders. The AIRAs remain a part of the Insurance Fund and are available to the Corporation. In fact, under the statute, Section 5.55 (e)(5), the AIRAs were designed to absorb losses first, if necessary.

AIRA allocations would be made only at the end of any year in which the Insurance Fund, plus the accumulated excess balance after deducting expenses and insurance obligations for the next year, is greater than the 2 percent SBA. If the Insurance Fund exceeds the SBA at the end of any calendar year (using December 31 balances), the statute requires the Corporation to determine whether any excess funds exist for allocation to the AIRAs. See Section 5.55 (e)(5). In determining whether excess funds exist, the statute calls for the Corporation to first calculate "the average secure base amount for the calendar year (using average daily balances)."

a. AIRAs as Excess Reserves

The statute contemplates that the Insurance Fund be made up of two tiers (the SBA and the excess AIRA balances). This reading of the statute is supported by the House Report on H.R. 2029 (H. Rep. 104-421) at page 9. In explaining the purpose and need for the Farm Credit Relief Act of 1996, it states that the legislation is designed to "provide for the rebate of interest accruing on the secure base amount." At another point on the same page, it explains that the legislation provides "for the disbursement of money above the secure base amount of the insurance fund that has accrued from excess interest" (emphasis added). In fact, section 5.55(e) is entitled "Allocation To System institutions of excess reserves." Clearly, Congress intended that the Insurance Fund would hold more funds than the SBA, with a partial disbursement of the excess after 2005, if no major losses occurred.

One commenter took issue with this reading of the statute and suggested that the Corporation consider counting the AIRAs in the SBA, rather than as an excess reserve. The Board believes the Policy Statement accurately reflects the statute and the legislative history. It conforms to the 1996 Act by providing a mechanism to contain future growth above the SBA due to investment income. The statute provides that the AIRAs are the first source of funds for the Corporation if actual operating expenses or insurance obligations exceed projections. Thus, the first source is the excess above the 2 percent and the second source is the amount below it.

The impact of the commenter's suggestion, counting the AIRAs toward the SBA, is to effectively lower the SBA from the unallocated 2 percent, without the Board determining that such a reduction is "actuarially sound." Furthermore, if you take this suggestion to its logical conclusion under a low growth scenario, the bulk of the Fund could be allocated to reserve accounts, eventually including even the $260 million in Treasury money and its accumulated interest. The Board does not believe that Congress contemplated either result.

b. Recalculating AIRAs Each Year or Fixing Them At Yearend

The proposed Policy Statement called for the AIRAs to be recalculated each year at calendar yearend. The amounts credited to the AIRAs would replace – rather than be added to – the amounts allocated the previous year. Thus, the amounts in the AIRAs would fluctuate, depending upon the annual calculation of the SBA and any excess Insurance Fund balance. The advantage of this approach is that any amounts in the AIRAs would be available to capitalize high growth in insured obligations. In other words, if growth during any year outstripped the ability of the Fund's investment earnings to capitalize it, then the AIRAs could be tapped to reach or maintain the 2 percent SBA. Using the AIRAs in this manner could reduce or eliminate the need to assess premiums. However, recalculating each year would also likely reduce the amount in the AIRAs during high growth years, limiting distributions and reducing the total amount of funds available in the event of insurance losses.

One commenter suggested that the Board treat the amounts in the AIRAs as fixed at yearend. Under this approach, any funds allocated to an AIRA account would be tapped in the following years only if an insurance loss occurs or to fund underestimated expenses. The commenter further suggested that the Fund could grow back to the SBA through investment earnings or if necessary by raising insurance premiums.

The approach taken in the proposed Policy Statement reflected the statutory language allocating excess funds at the end of the year <u>if the Insurance Fund exceeds the SBA for that year</u>. While the Board believes it is reasonable and consistent with the statute to recalculate the AIRAs each year concurrent with the SBA calculation, it agrees with the commenter that it is also reasonable to treat the amounts in the AIRAs as fixed at yearend. Fixing the AIRAs is consistent with the statutory language describing how FCSIC should use the funds in the AIRAs. In fact, there is a tension in the statute between this part and the part that describes how to allocate funds to the AIRAs. The Board believes it could resolve this tension by choosing either method because both are reasonable interpretations of the statute.

By agreeing with the commenter and fixing amounts placed into the AIRAs, more money will be retained during high growth years. This clearly benefits the AIRA account holders. However, the System may have to pay insurance premiums after a year where high growth in insured obligations causes the Fund to fall below the SBA; but as the commenter pointed out, the Board has clear authority to assess premiums in this circumstance. Also, the commenter noted that premiums would be paid on the basis of risk and growth rather than at the expense of AIRA account holders. For investors in the Systemwide debt, the aggregate value of the Insurance Fund will be higher in high growth years when insurance premiums are collected. Thus, this method has some advantages that are not present in yearend recalculation described in the proposed Policy Statement. For these reasons, the Board has decided not to recalculate the AIRAs each year but instead to fix the amounts at year-end.

c. Authorized Deductions

If the Insurance Fund exceeds the SBA, the statute requires that the Insurance Fund balance be adjusted downward by an estimate for the next calendar year of the:

1. Corporation's operating costs and

2. Insurance obligations.

The Corporation will deduct the operating expenses it expects to incur for the next calendar year. Estimated insurance obligations are defined in the Policy Statement to include all anticipated allowances for insurance losses, claims, and other potential statutory uses of the Insurance Fund.

The Corporation prepares its financial statements on an accrual basis using generally accepted accounting principles (GAAP). GAAP requires the Corporation to recognize in its financial statements any probable loss that can be reasonably estimated. Thus, the Board has concluded that the Corporation should deduct probable losses estimated for the next year, recognizing that such a deduction could mean that no excess funds would be available for allocation to the AIRAs in a given year.

The proposed Policy Statement defined insurance obligations to include an estimate of expected growth in insured debt for the prospective 12 months, using a 3-year average to determine the estimate. The statute grants the FCSIC, in its sole discretion, the authority to determine the sum of its estimated operating expenses and insurance obligations for purposes of determining if an excess Fund balance exists for allocation to the AIRAs. Accordingly, it is reasonable for the Board to exercise this discretion to include an amount necessary to adjust the Fund for anticipated growth in the System's insured debt. Including an anticipated growth factor as an authorized deduction from the excess balance will diminish the amount available for allocation to the AIRAs. Investors, however, would have a greater cushion of insurance protection.

System institutions that commented did not favor this approach because they may not receive as much in AIRA allocations. One commenter stated that covering growth out of excess reserves causes those who are not growing to subsidize out of their AIRAs the insurance premiums of those that are growing. Also, the commenter argued that including a deduction for estimated growth is not what Congress intended.[1] The commenter suggested that estimated growth should be considered when the Board reviews insurance premiums, not in the AIRA formula. This commenter also suggested that if the Board decided to include estimated growth, it should also include estimated investment earnings as a compensating factor. The Board agrees that it is reasonable to calculate operating expenses as a "net" figure by including estimated earnings if it adjusts the Insurance Fund for estimated growth.

The Board also agrees that it can and should consider growth estimates when it reviews insurance premiums. Thus, the Board has decided not to include an estimated growth factor as an authorized deduction in determining if an excess Fund balance exists for allocation to the AIRAs. As a result, neither estimated growth nor estimated earnings will be included. Only estimated operating expenses and insurance obligations for the prospective 12 months will be deducted.

d. Allocation Formula When Excess Funds Are Available

The Policy Statement includes the statutory formula for allocation of any excess Insurance Fund balances to FAC stockholders (10 percent) and to the insured System banks (90 percent). It also includes the 3-year average loan balance formula the statute mandates when the Corporation adds balances to each AIRA. The commenters did not question this approach. Exhibit 1 is a hypothetical example of how the AIRA program will operate. It compares the approach used in the proposed Policy Statement to the final approach, including determining the amount of excess Insurance Fund balances and allocating the balances to individual AIRA holders.

e. Use of Allocated Amounts When Reductions Are Required

The Policy Statement also interprets the statutory language governing use of the AIRAs when insurance obligations exceed estimated amounts. When actual expenses and insurance obligations exceed estimates from the previous yearend, the law requires the Corporation to reduce the balances in the AIRAs by proportional amounts. The statute, however, doesn't prescribe how the proportional amounts are to be determined.

The Board concluded that the Corporation should use the same technique to calculate reductions to the AIRAs as the statute uses to calculate additions, i.e., the 3-year average loan balance formula. This weighted average allocation formula ensures that any reductions to AIRA balances are accomplished in the same manner as the allocations. The commenters did not take issue with this approach.

2. AIRA Accumulation Cycle

The law authorizes payments of a portion of AIRA balances to the System banks and FAC stockholders "as soon as practicable during each calendar year beginning more than 8 years after the date on which the aggregate of the amounts" in the Insurance Fund exceeds the SBA. (12 U.S.C. § 2277a-4). While this language could be subject to varying interpretations, the Insurance Fund

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[1] This commenter also took issue with a reference in the preamble that noted how a deduction for estimated growth might avoid the need for "supplemental insurance premiums." FCSIC recognizes that Congress did not embrace the concept of "supplemental premiums." A better choice of words would have been "might avoid the need to assess additional premiums to build back to the SBA."

first attained the SBA in the first quarter of 1998, and thus payments could begin 8 years later. The Board has concluded that it is reasonable to consider making the first payment as soon as practicable after the first quarter in 2006. The proposed Policy Statement adopts the earliest possible payout date: 8 calendar years after the quarter-end when the SBA was initially attained. The commenters supported this approach.

An important corollary issue is how to address an interruption in the 8-year period. For example, if after establishing the AIRAs, the Corporation has to use them for an insurance action, does the accumulation cycle begin anew? The Policy Statement: 1) grants the Board the authority to restart the accumulation period if the Insurance Fund drops below the SBA at any subsequent quarter-end during the 8-year period; 2) allows the Board to select an accumulation period, to begin at the next quarter-end when the Insurance Fund again attains the SBA; and 3) enumerates the factors the Board will consider in selecting an alternative accumulation period.

The statute grants the Board discretionary authority to determine whether to make distributions at the end of the 8-year AIRA accumulation cycle. Given this broad authority and the overall statutory scheme, it is reasonable for the Board to interpret the statute to permit it to change or restart the AIRA cycle if, at any time during this period, the Insurance Fund drops below the SBA.

The Policy Statement leaves the issue of selecting an alternative accumulation period open to decision on a case-by-case basis. This approach preserves maximum flexibility to tailor any alternative accumulation period to best fit the causes of a future shortfall in the Insurance Fund. For example, the circumstances where a period of rapid growth causes a temporary (or small) decline in the Insurance Fund below the SBA for one or more quarters are far less serious than a decline in the Insurance Fund caused by losses as a result of increased risk at System banks and associations.

One commenter found the Board's approach to be "reasonable and sound." Another commenter did not take issue with the Board's discretionary authority to change or restart the 8-year AIRA cycle. It suggested, however, it would be inappropriate to delay the period when payouts begin if there is a temporary reduction below the SBA.[2] As noted above, the Board agrees this would be less serious than a substantial reduction due to insurance losses.

III. Issues for Later Consideration

The statute authorizes initial payment of any balances in the AIRAs beginning more than 8 years after attainment of the SBA, which could be as early as 2006. As this date approaches, the Corporation's Board will have to consider the Corporation's authority to reduce or eliminate AIRA payments, and calculation of the initial AIRA payment components.

The Board believes that these issues can be better addressed after the Corporation obtains experience in administering the AIRA program over several years. Also, the likelihood of payment beginning in 2006 must be considered somewhat uncertain at this time. The uncertainty stems from factors that will determine whether and how much of any AIRA accumulations will occur. These factors are:

[2] This same commenter took issue with the preamble's characterization of the 8-year accumulation period as established by Congress to "allow for the creation of a secondary insurance reserve." We have eliminated the reference.

1. Future growth in the level of insured debt outstanding;
2. Possible insurance claims or losses; and the
3. Level of investment earnings.

Because the Corporation cannot predict any of these factors with certainty now, it seems prudent to gain more experience with excess Insurance Fund balances before making these decisions about future payments. The commenters did not disagree with this approach.

FARM CREDIT SYSTEM INSURANCE CORPORATION
POLICY STATEMENT ON THE SECURE BASE AMOUNT AND ALLOCATED INSURANCE RESERVE ACCOUNT PROGRAM

Effective Date: Upon adoption.

Effect on Previous Action: None

Source of Authority: Section 5.55 of the Farm Credit Act of 1971, as amended (the Act); 12 U.S.C. § 2277a-4

WHEREAS, section 5.52 of the Act established the Farm Credit System Insurance Corporation (Corporation) to, among other things, insure the timely payment of principal and interest on Farm Credit System obligations (12 U.S.C. § 2277a-1); and

WHEREAS, section 5.55 of the Act mandates that the Corporation will build and manage the Farm Credit Insurance Fund (Insurance Fund) to attain and maintain a secure base amount (SBA), defined as 2 percent of the aggregate outstanding insured obligations of all insured System banks (excluding a percentage of state and Federally guaranteed loans) or such other percentage of the aggregate amount as the Corporation in its sole discretion determines is actuarially sound; and

WHEREAS, the Farm Credit System Reform Act of 1996, Pub.L.No. 104-105, 110 Stat. 162 (Feb. 10, 1996), amended section 5.55 of the Act to: 1) Establish in the Insurance Fund an Allocated Insurance Reserve Account (AIRA) for the benefit of each insured System bank and one for the Farm Credit System Financial Assistance Corporation (FAC) stockholders; 2) Allocate any excess balances above the SBA to these AIRAs; and 3) Eventually make partial distributions of the excess funds in the AIRAs.

NOW, therefore, the Corporation's Board of Directors (Board) adopts the following Policy Statement to govern the calculation of the secure base amount, the determination of any excess above the SBA, the establishment of the AIRAs, and the method for allocating any excess to the AIRAs.

I. SECURE BASE AMOUNT DETERMINATION

As stated in the Corporation's Policy Statement Concerning Adjustments to the Insurance Premiums (BM-11-JUL-96-02), the Board will review the premium assessments at least semiannually to determine whether to adjust premiums in response to changing conditions. The Board continued this review even after the Insurance Fund achieved the SBA because the law requires the Corporation to maintain the SBA. Thus, the Corporation must ensure that as the Farm Credit System's insured debt grows, or if the Insurance Fund suffers a significant loss, the Insurance Fund builds back to the SBA.

The Farm Credit Reform Act of 1996 established a process for making partial distributions of the Insurance Fund's balance above the SBA. If excess reserves accumulate, these distributions can begin at a point 8 years after the Insurance Fund reaches the SBA, but no sooner than 2005. The Insurance Fund first attained the SBA in 1998, and thus the payments could begin 8 years later. To begin the process the Corporation must define "the aggregate outstanding insured obligations" of all the System banks. Then it must follow the steps in the statute to determine the SBA. Finally, at the end of any calendar year in which the Insurance Fund attains the secure base amount, the Corporation must determine whether any excess funds exist for allocation to the AIRAs.

The principal calculation for determining whether the Insurance Fund is at the SBA amount will be 2 percent of the aggregate adjusted insured obligations defined as follows:

1. "Insured obligation" means any note, bond, debenture, or other obligation issued under subsection (c) or (d) of section 4.2 of the Farm Credit Act on or before January 5, 1989, on behalf of any System bank; and after such date which, when issued, is issued on behalf of any insured System bank and is outstanding at the quarter-end. The balance outstanding at the quarter-end shall include principal and accrued interest payable as reported by the banks in the call reports submitted to the Farm Credit Administration.

2. The balance of insured obligations determined in Number 1 shall be reduced by an amount equal to the sum of:

a) 90 percent of the guaranteed portions of principal outstanding on Federal Government-guaranteed loans in accrual status at all System institutions; and

b) 80 percent of the guaranteed portions of principal outstanding on State Government-guaranteed loans in accrual status at all System institutions.

At the end of any calendar year when the Insurance Fund balance exceeds the SBA, calculated using December 31, balances (point-in-time method), the Corporation will determine whether any excess funds exist for allocation to the AIRAs.

II. ALLOCATED INSURANCE RESERVE ACCOUNTS

1. Determination of Excess Insurance Fund Balances

An allocated insurance reserve account (AIRA) shall be established in the Insurance Fund for each insured System bank and for FAC stockholders. Amounts representing excess Insurance Fund balances would be allocated to the AIRAs. The AIRAs remain a part of the Insurance Fund and are available to the Corporation.

a) Authorized Deductions

In determining whether there are any excess insurance reserves, the December 31 Insurance Fund balance will first be adjusted downward by:

(1) The Corporation's estimated operating expenses for the next 12 months; and

(2) The Corporation's estimated insurance obligations for the next 12 months.

The Corporation will budget for the next calendar year operating expenses and it will deduct the operating expenses it expects to incur. When determining estimated insurance obligations, the Corporation will include all anticipated allowances for insurance losses, claims, and other potential statutory uses of the Insurance Fund.

The adjusted aggregate yearend Insurance Fund balance will then be compared with the SBA. The Corporation will calculate the SBA using an average daily balance method for the previous calendar year. The statute requires use of an average daily balance method for calculating the SBA <u>only</u> for purposes of determining the amount of any excess Insurance Fund balances.

When the aggregate adjusted Insurance Fund balance exceeds the SBA calculated using the average daily balance method, the excess Fund balance shall be allocated to the accounts of each insured System bank and to the FAC stockholders. The AIRA balances will be fixed at year-end and any amounts to be credited in subsequent years will be added to amounts allocated the previous year.

b) Allocation Formula When Excess Funds Are Available

(1) Ten percent of the excess Insurance Fund balance shall be credited to the AIRA for all holders, in the aggregate, of Financial Assistance Corporation stock. The total amount that may be allocated to this AIRA is limited to $56 million.

(2) The remaining amount of the excess Insurance Fund balance shall be credited to the AIRAs for each insured System bank. The basis for crediting the excess balance to each bank's AIRA shall be the ratio of its average daily accrual loan principal outstanding for the three prior years divided by the total average daily accrual loan principal outstanding for all System banks. System bank loan volume for making these allocations is defined in section 5.55(d) to include all retail loans made by direct lending associations, their insured System banks and other financing institutions (OFIs) being financed by insured System banks (12 U.S.C. § 2277a-4 (d)). The statute also requires that a reduction be made from each bank's ratio (numerator and denominator) for the guaranteed portions of government-guaranteed loans similarly on an average daily balance basis for the three-year period. An example of the allocation formula is shown in Exhibit 1.

c) Use of Allocated Amounts When Reductions Are Required

When the Corporation's actual operating expenses and insurance obligations exceed the estimated amounts used to determine any year's AIRA balances, section 5.55(e)(5) requires AIRA balances to absorb such excess expenses before using other amounts in the Insurance Fund (12 U.S.C. § 2277a-4(e)(5)). To the extent reductions are made in AIRA balances to absorb Corporation expenses and actual insurance obligations, each AIRA will be reduced by its proportional amount in accordance with the statute. The same formula used to make allocations of excess Insurance Fund balances shall be used to reduce AIRA balances when necessary. Ten percent of any necessary AIRA reduction will be applied to the FAC stockholder AIRA. The remaining 90 percent will be applied to the System insured banks'

AIRAs on the basis of the ratio of each bank's average daily accrual loan principal outstanding for the three prior years divided by the total average daily accrual loan principal outstanding for all System banks.

2. <u>AIRA Accumulation Cycle</u>

Section 5.55(e)(6) permits the Insurance Corporation's Board at its discretion to make payments of AIRA balances to the account-holders after a minimum time period (12 U.S.C. § 2277a-4(e)(6)). The minimum time period specified is more than 8 years after the date on which the aggregate amount in the Insurance Fund exceeds the secure base amount calculated using quarter-end balances.

The initial starting point for the 8-year period shall be the first calendar quarter-end when the Insurance Fund has attained or exceeded its SBA. The initial attainment occurred during the first quarter of 1998. The first payment would be in the second quarter of 2006.

Should the Insurance Fund drop below the secure base amount at any subsequent quarter-end during the 8-year period, the Corporation's Board may restart the accumulation period. For example, the Insurance Fund might drop below the SBA as a result of rapid growth in insured System debt outstanding, or incurring insurance claims or losses. The Board in its discretion may select an accumulation period, to begin at the next quarter-end when the aggregate in the Insurance Fund again attains the secure base amount. Any alternative accumulation period however, cannot result in any payment before April 2006. The Board will consider the following factors in determining selection of an alternative accumulation period:

a) The reason that the Insurance Fund dropped below the SBA (i.e. as a result of growth in insured debt vs. an insurance expense at a troubled institution). The current level of the Insurance Fund and the amount of money and time needed to attain the SBA;

b) The likelihood and probable amount of any losses to the Insurance Fund;

c) The overall condition of the Farm Credit System, including the level and quality of capital, earnings, asset growth, asset quality, loss allowance levels, asset liability management, as well as the collateral ratios of the insured banks;

d) The health and prospects for the agricultural economy, including the potential impact of governmental farm policy and the effect of the globalization of agriculture on opportunities and competition for U.S. producers; and

e) The risks in the financial environment that may cause a problem, even when there is no imminent threat, such as volatility in the level of interest rates, the use of sophisticated investment securities and derivative instruments, and increasing competition from non-System financial institutions.

III. ISSUES FOR LATER CONSIDERATION

Because of multiple factors (including rapid growth and the amount of any insurance obligations) which could affect future AIRA balances and the uncertainty of future payments, the Corporation has deferred consideration of several issues to a date closer to the year 2006. The Board anticipates gaining experience in the administration of the AIRA program over the next few years and expects to have a better basis for determining these issues, which include:

1. Board discretionary authority to limit or restrict AIRA payments; and

2. Calculation of the initial AIRA payment components.

DATED THIS 15th DAY OF DECEMBER, 1999.

BY ORDER OF THE BOARD

Vivian L. Portis
Secretary to the Board

Allocated Insurance Reserve Account Program

Exhibit 1

Hypothetical Example: Determination of Excess Insurance Fund Balance

($ Millions)			Initial Proposed	Final
Insurance Fund Balance at December 31, XXXX			$ 1,265.0	$ 1,265.0
Less:	Est. FCSIC Operating Expenses for XXXY		$ (1.8)	$ (1.8)
	Est. FAC Provision for XXXY		$ (9.7)	$ (9.7)
	Est. Growth in Insured Debt Factor for XXXY (3.5%)		$ (42.7)	$ -
Adjusted Insurance Fund Balance			**$ 1,210.8**	**$ 1,253.5**
Secure Base Amount Calculation (Using Average Daily Balances) :				
Insured Systemwide and Consolidated Debt Outstanding		Principal	$62,500.0	$ 62,500.0
		Accrued Interest Payable	$ 600.0	$ 600.0
	Total		$63,100.0	$ 63,100.0
Less :	90% of guaranteed portions of Federal Government guaranteed loan principal		$ (3,500.0)	$ (3,500.0)
	80% of guaranteed portions of State government guaranteed loan principal		$ (8.0)	$ (8.0)
Adjusted Insured Debt Outstanding			$59,592.0	$ 59,592.0
Secure Base Amount			**$ 1,191.8**	**$ 1,191.8**
Excess Insurance Fund Balance (Adjusted Ins. Fund Balance less Secure Base Amount)			**$ 19.0**	**$ 61.7**

Amount to be allocated to Banks and FAC AIRAs	$ 19.0	$ 61.7

Hypothetical Example: Allocation Formula

				($ Millions)	Initial Proposed	Final
FAC Stockholders in aggregate (10% of Allocable Amount)					$ 1.9	$ 6.2
Banks (90%) based on prior three years average accrual loan principal outstanding						
	Average Daily Balances of Accrual Loan Principal					
	Prior Year	Prior Year -1	Prior Year -2	3 Year Avg.		
Bank 1	$ 16,450	$ 15,700	$ 15,400	$ 15,850	$ 4.8	$ 15.5
Bank 2	$ 15,500	$ 15,600	$ 15,000	$ 15,367	$ 4.6	$ 15.0
Bank 3	$ 4,000	$ 3,600	$ 3,500	$ 3,700	$ 1.1	$ 3.6
Bank 4	$ 4,400	$ 3,950	$ 3,800	$ 4,050	$ 1.2	$ 4.0
Bank 5	$ 4,500	$ 4,100	$ 3,950	$ 4,183	$ 1.3	$ 4.1
Bank 6	$ 6,450	$ 6,100	$ 5,700	$ 6,083	$ 1.8	$ 5.9
Bank 7	$ 8,200	$ 7,400	$ 7,100	$ 7,567	$ 2.3	$ 7.4
Totals	$ 59,500	$ 56,450	$ 54,450	$ 56,800	$ 17.1	$ 55.5