

Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC36

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Risk-Based Capital Requirements

AGENCY: Farm Credit Administration.
ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, us, or we) adopts a proposed rule that would amend regulations governing the Federal Agricultural Mortgage Corporation (Farmer Mac or the Corporation). We propose to update the model in response to recent additions to Farmer Mac's program operations that are not addressed in the current version of the model. We propose to amend the current model's assumption regarding the carrying cost of nonperforming loans to better reflect Farmer Mac's actual business practices. We further propose to add a new component to the model to recognize counterparty risk on nonprogram investments through application of discounts or "haircuts" to the yields of those investments and to make technical amendments to the layout of the model's Credit Loss Module. The effect of the rule is to update the model so that it continues to appropriately reflect risk in a manner consistent with statutory requirements for calculating Farmer Mac's regulatory minimum capital level.

DATES: You may send us comments by October 29, 2007.

ADDRESSES: We offer several methods for the public to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site or the Federal eRulemaking Portal. 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.
- *Agency Web site:* <http://www.fca.gov>. Select "Legal Info," then "Pending Regulations and Notices."
- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *Mail:* Robert Coleman, Director, Office of Secondary Market Oversight, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.
- *FAX:* (703) 883-4477. Posting and processing of faxes may be delayed, as faxes are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act. Please consider another means to comment, if possible.

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 "Legal Info," and then select "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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SUPPLEMENTARY INFORMATION:

I. Purpose

It is the Agency's objective that the risk-based capital stress test (RBCST) continue to determine regulatory capital requirements consistent with statutory requirements and constraints. The purpose of this proposed rule is to revise the risk-based capital (RBC) regulations that apply to Farmer Mac to more accurately reflect changes in Farmer Mac's operations or business practices. The substantive issues addressed in this proposed rule are treatment of program loan volume with

certain credit enhancement features (e.g., Off-Balance Sheet AgVantage volume, subordinated interests, and program loan collateral pledged in excess of Farmer Mac's guarantee obligation (hereafter, "overcollateral")), counterparty risk on nonprogram investments, and the resolution timing for nonperforming loans and associated carrying costs. We also propose minor formatting changes to the structure of the Credit Loss Module that are in the nature of technical changes.

II. Background and Summary of Revisions

In 2006, Farmer Mac initiated a program to guarantee timely repayment of principal and interest on notes that are collateralized by Farmer Mac-eligible agricultural real estate mortgage assets and are also secured by an obligation of the mortgage lender. We will refer to this product as Off-Balance Sheet AgVantage. The first such transaction was a guarantee of \$500 million in guaranteed notes announced by Farmer Mac on January 23, 2006. Subsequently, Farmer Mac announced similarly structured transactions for \$1 billion each on July 13, 2006, and April 11, 2007. The current version of the RBCST lacks a component to recognize the credit enhancement provided by the lender's obligation and, consequently, this volume is excluded from the modeled loan portfolio. We propose to begin including this product in the RBCST model. Further, in the event that Farmer Mac introduces products that include a subordinated interest retained by the primary lender, we propose a modeling treatment of such structures.

We proposed revisions to the treatment of nonprogram investments and the carrying cost of nonperforming loans in our rule published in November 2005.¹ We did not adopt those proposed revisions in the final rule that amended other parts of the model.² We now propose revisions to these two components that differ somewhat from those proposed in November 2005. We propose to account for counterparty risk on nonprogram investments by applying a discount (or "haircut") to the yields of nonprogram investments scaled according to credit ratings, with a 10-year phase-in. We propose a method of calculating the

¹ 70 FR 69692 (November 17, 2005).

² 71 FR 77247 (December 26, 2006).

carrying cost of nonperforming loans over a period we refer to as the Loan Loss Resolution Time period, or “LLRT”, that will include a quarterly update of the LLRT estimate.

Finally, we propose other technical changes to improve formatting and clarity of labeling in certain cells of the Credit Loss Module worksheets.

III. Issues, Options Considered, and Proposed Revisions

A. Treatment of Off-Balance Sheet AgVantage Program Volume

In 2006, Farmer Mac initiated a program to guarantee the timely repayment of principal and interest on notes that, in addition to being collateralized by Farmer Mac-eligible agricultural real estate mortgages, are also secured by an obligation of the primary lender of those mortgages. The current version of the model lacks a component to recognize the credit enhancement provided by the issuer’s general obligation and any contractually required loan collateral in excess of the face value of the guaranteed notes.

We propose to revise the model to include this program volume by modeling all loans in guaranteed note portfolios in the same manner as all other program volume, with two differences. The first difference would recognize the risk mitigation provided by the general obligation by reducing the age-adjusted dollar losses estimated on the subject loans by an adjustment factor derived from historical default rates by the whole letter credit ratings of corporate bond issuers as reported by a nationally recognized statistical rating organization (NRSRO). The second difference would address the risk-reducing effects of contractually

required overcollateralization of the subject portfolio, if any.

The derivation and application of the general obligation adjustment factor would be as follows. We would define five levels of credit ratings from “AAA” to “below BBB and unrated.” We would assign each of the NRSRO-rating categories to one of the five general whole-letter rating categories we define. The adjustment factors applied would be equal to the average cumulative issuer-weighted, 10-year corporate default rates from 1920 through the most recent year as published by Moody’s Investor Services.³ For issuers that are rated below BBB or are unrated, the model would apply a factor equal to the 10-year corporate default rates on Speculative-Grade bonds published in the same report. This rate would then be further adjusted to obtain an estimated loss rate related only to a general obligation of the corporate issuer/Off-Balance Sheet AgVantage counterparty with a given credit rating by considering the loss-severity rate as implied by recovery rates published in the same annual Moody’s report (i.e., 1 minus recovery rate). In this case, because recovery rates are not published by whole-letter credit rating categories in the Moody’s report, we would apply a loss severity implied by Moody’s average Defaulted Bond Recovery Rates by Lien Position for as long a period as the Moody’s report provides. Moody’s 2006 report includes a table of data on recovery rates from 1982 to 2006. We propose to adopt a severity rate adjustment to historical corporate default rates based on the published long-term recovery rate for senior unsecured bonds. We considered using the recovery rates of the “All Bonds” category to calculate implied loss-severity rate factors but rejected that

approach because we believe that the senior unsecured category is likely to reflect a more accurate analog of a general obligation than a “catch-all” category like “All Bonds” that would include senior secured bond and subordinated bond categories in addition to the senior unsecured category. We believe that neither of these bond lien position categories reflects the nature of a general obligation as accurately as the senior unsecured category.

We considered whether the senior secured category might be more applicable, given the mortgage loans that collateralize this obligation. However, we believe our proposed application is justified because, in the RBCST’s Credit Loss Module, we target an estimate of the ultimate loss rate associated with the occurrence of what are assumed to be independent events (a corporate default and agricultural mortgage loan pool defaults). For example, suppose that a counterparty utilizing Farmer Mac’s Off-Balance Sheet AgVantage product goes bankrupt. We assume that the default event is uncorrelated with the occurrence of worst-case stress in the agricultural lending sector. Therefore, we treat the estimated loss rate calculation on the general obligation separately from the estimated loss rate calculation on the program loan collateral. Thus, we believe the estimation of a counterparty default/severity rate should be done separately from and without regard to the loan collateral and, therefore, that the senior unsecured severity rate is most appropriate.

The following table sets forth the proposed credit loss adjustment factors and their components (Adjustment Factor = Default Rate × Severity Rate).⁴

Whole letter rating	Default rate (percent)	Severity rate (percent)	General obligation adjustment factor (percent)
AAA	0.89	55	0.49
AA	2.31	55	1.26
A	2.90	55	1.58
BBB	7.29	55	3.98
Below BBB and Unrated	27.39	55	15.16

The adjustment factors would be updated quarterly as the updated Moody’s report on Default and Recovery Rates of Corporate Bond Issuers becomes available. In the event that there is an interruption of Moody’s

publication of this annual report, or FCA informs Farmer Mac it has determined that the report has changed so much that it prevents or calls into question the identification of suitable updated factors, the prior year’s factors

would remain in effect until FCA revises the process through rulemaking.

In addition, the loan portfolio collateral underlying Off-Balance Sheet AgVantage volume may contain loan collateralization in excess of the face

³ Hamilton, D., Ou S., Kim R., Cantor R., “Corporate Default and Recovery Rates, 1920—2006,” published by Moody’s Investors Service,

February 2007—the most recent edition as of April 2007.

⁴ Ibid; Default Rates, page 22, Recovery Rates (Severity Rate = 1 minus Senior Unsecured Average Recovery Rate) page 18.

value of the note. This overcollateral may be contractually required or it may be provided by the issuer of the guaranteed note to reduce administrative expense associated with monitoring the eligibility of the collateral, or both. We view overcollateral in excess of contractually required amounts as solely an administrative convenience for the lender in question. When there is excess overcollateral, any loan in the overcollateral can automatically be deemed to replace a loan that might become ineligible under the AgVantage contract without the need for additional action on the part of either party. However, when it is discretionary and not contractually required, the amount of excess overcollateral provided by Farmer Mac's counterparty is subject to change at any time. Therefore, we believe that overcollateral that is required by contract and is not simply an administrative convenience should be recognized in the model for the risk mitigation it provides, but that the additional collateral provided solely for administrative convenience should not.

Whenever overcollateral exists, we model a portfolio that is larger than the dollar amount of Farmer Mac's guarantee obligation because there is no direct means to segregate a specific set of loans in the total collateral portfolio that could be considered to comprise 100 percent of the face value of the guaranteed notes. We then need an adjustment to reduce the amount of submitted loan collateral for purposes of estimating credit losses in the Credit Loss Module (CLM) in order to avoid the model's recognition of the credit risk on loan volume that is in excess of the contractually required volume.

Given the above considerations, we propose the following treatment. The Off-Balance Sheet AgVantage volume will be modeled using separate worksheets of the CLM with added features to:

- (1) Scale the estimated losses to be commensurate with losses associated with the contractually required minimum collateral. To achieve this, we multiply the estimated dollar losses of each loan after age adjustment by the ratio of the guaranteed amount to total submitted loan collateral; and
- (2) Recognize the risk mitigation provided by the contractually required overcollateralization. To do so, expected losses after the adjustment in "(1)" above are compared to the dollar amount of contractually required overcollateral, and any estimated credit loss dollars in excess of the contractually required overcollateral are input in the model as loss rates applied to that pool's underlying portfolio volume.
- (3) Recognize the risk mitigation provided by the counterparty's general obligation. This

is accomplished by multiplying any remaining losses after the adjustments in "(1)" and "(2)" above by the appropriate general obligation adjustment factor according to the counterparty's whole-letter issuer credit rating (set forth in the table above) to reflect the likelihood of exhausting the capacity of the issuer to maintain adequate collateral.

We acknowledge that the order of these adjustments may seem incongruous with the legal structure of a given transaction, but we believe the proposed order makes sense from a modeling perspective. For example, the counterparty's general obligation might legally be first in terms of the security provided in support of Farmer Mac's risk position—followed by access to the loan collateral after an event of default by the counterparty. However, we adjust for the risk-mitigation of the contractually required overcollateralization first, followed by the adjustment for the general obligation. As a practical matter, we believe that Farmer Mac, to make itself whole on any losses after the counterparty defaults, would first work through the overcollateral, which would be held by a bankruptcy-remote vehicle. Only after that overcollateral proved insufficient to make Farmer Mac whole, would it need to pursue further recovery from the counterparty.

B. Add a Treatment for Products that Could Include a Subordinated Interest Retained by the Primary Lender or Seller

In the event Farmer Mac introduces new products that include the specific retention of a portion of the credit risk at either a loan level or a pool level by the primary lender or seller, this loan volume would also be modeled in separate worksheets of the CLM. The model would recognize the subordinated interest by multiplying the age-adjusted dollar losses in the subject portfolio by one minus the percentage of the subordinated interest in order to isolate the portion of estimated loss that Farmer Mac would incur. To the extent that such structures include further stratification of losses, such as a cap on the exposure to losses assumed by Farmer Mac, such stratification would be treated in a similar manner.

C. Add Haircuts on Nonprogram Investments

Currently, the RBCST does not include a component to reflect counterparty risk on Farmer Mac's portfolio of nonprogram investments or its derivatives. We propose adopting a system of haircuts to the yields on investment securities scaled according to credit ratings, with larger haircuts

applied to cash flows from investments from issuers with lower credit ratings. We previously proposed haircuts in our November 2005 proposed rule but did not include them in our final rule published on December 26, 2006.

The previously proposed rule based investment haircuts on the risk-based capital regulations of the Office of Federal Housing Enterprise Oversight (OFHEO) (12 CFR part 1750). OFHEO's haircut levels were based on worst-case corporate bond default rates using Depression-era default rates and recovery rates, expanded to a 10-year period. For all counterparties, the default rates used were 5 percent for AAA, 12.5 percent for AA, 20 percent for A, 40 percent for BBB and 100 percent for below BBB or unrated. Severity rates used were 70 percent for nonderivative securities, yielding net haircuts of 3.5 percent, 8.75 percent, 14.0 percent, and 28.0 percent for ratings AAA through BBB, respectively. One hundred percent (100%) haircuts were applied to the "BBB or unrated" category. Our November 2005 proposal contained the same haircut levels as in OFHEO's regulations.

We decided not to adopt the November 2005 haircut proposal out of concern that the worst-case perspective on historical default rates is not as appropriate for Farmer Mac as it is for the housing Government-sponsored enterprises (GSEs). While it is plausible that worst-case stress in the housing markets could be highly correlated with worst-case conditions throughout the economy as exhibited by corporate bond defaults, we believe that worst-case agricultural credit conditions would likely be far less correlated with events of major stress in financial markets generally. Therefore, we have based the haircuts in this proposed rule on average bond default rates rather than worst-case historical corporate defaults. In addition, we have chosen not to follow a similar method for expansion of the worst case interval to the 10-year time interval. Instead, we propose a more direct reliance on empirical evidence and base the haircuts on Moody's Average 10-year cumulative issuer-weighted corporate default rates by whole letter rating, adjusted by the average implied long-term severity rate for Senior Unsecured bonds. The weighted-average yields of non-program investment categories would be reduced by the haircut percentage phased in linearly over the 10-year modeling horizon. The haircut levels are the same as the loss rate adjustment factors proposed above for application on loans underlying guaranteed notes, and like those factors these will be updated as

new information becomes available. The proposed investment haircuts to recognize counterparty risk are as follows:

Whole letter credit rating	Haircut (percent)
AAA	0.49
AA	1.26
A	1.58
BBB	3.98
Below BBB and Unrated	15.16

We propose to phase in the haircuts over the 10-year modeling horizon, based on our assumption that defaults on investments in response to a general downturn in the economy would not be instantaneous but rather spread through time. Furthermore, consistent with the OFHEO rule, we would not assign the rating of a parent company to its unrated subsidiary because NRSROs will not impute a corporate parent's rating to a derivative or credit enhancement counterparty in the context of a securities transaction, and because extending that rating to the unrated subsidiary would be tantamount to the regulator rating the subsidiary.⁵ However, when an investment is structured as a collateralized obligation backed by the issuer's general obligation and, in turn, a pool of collateral, we accept the issuer rating of that issuer as the credit rating applicable to the security. Unrated securities that are fully guaranteed by GSEs receive the same treatment as AAA securities. Unrated securities backed by the full faith and credit of the U.S. Government do not receive a haircut.

In the event that FCA approves the purchase of an unrated investment, and portions of that investment with specific risk characteristics are later sold by Farmer Mac, the Director will take reasonable measures to adjust the haircut level applied to the investment to recognize the change in the risk characteristics of the retained portion. In taking these measures, the Director will consider the approaches taken to address capital requirements related to similar investments that have been adopted by other Federal financial institution regulators.

We propose to apply the haircuts to yields on a weighted-average basis by investment categories established in the "Data Inputs" worksheet of the RBCST, e.g., commercial paper, corporate debt and asset-backed securities, agency mortgaged-backed securities and collateralized mortgage obligations. This treatment would require Farmer Mac to

calculate the weighted-average haircut by investment category to be applied to the weighted-average yields for each investment category and to input the haircuts into the "Data Inputs" worksheet. The proposed haircuts are set forth in the table in paragraph e. of section 4.1 in the appendix A, subpart B of part 652.

We considered proposing a similar haircut on derivative securities, on the ground that credit stress that impacts Farmer Mac's nonprogram investment portfolio would reasonably be expected to affect its derivatives counterparties and its terms of access to the swap market.⁶ We believe a more appropriate approach to haircutting derivatives may be to reflect lost payments on defaulted derivative securities in a net-receive position, as well as the "replacement cost"—i.e., the additional expense associated with the replacement of derivative positions when the counterparty defaults and the market value of the derivative has increased since the date the defaulted derivative contract was executed. Such an increased market value would be to Farmer Mac's benefit when the counterparty does not default, but to its detriment when it does default. The Agency plans to address this issue in future revisions of the RBCST and specifically requests comment on the most appropriate approach to incorporate into the RBCST such "replacement cost" risk relating to derivative securities.

D. Improve the Estimate of Carrying Costs of Nonperforming Loans by Revising LLRT Assumptions

The RBCST was originally developed with a loss-severity estimate that assumes it would take Farmer Mac 1 year to work through problem loans from the point of default through final disposition. An estimate was used because, at the time of development of the RBCST, historical nonperforming loan resolution timing data from Farmer Mac were not sufficient. Farmer Mac data collected since that time indicate that an adjustment to the 1-year assumption to recognize Farmer Mac's actual historical experience is appropriate. If the actual historical time interval is longer than the current model's assumption, the capital needs for carrying nonperforming assets are likely understated in the model. Therefore, we propose amendments to the model to reflect costs associated

⁶The term "derivative" refers to over-the-counter financial derivative instruments used by Farmer Mac to hedge interest rate risk and synthetically extend the term structure of its debt to reduce funding costs.

with any additional time period over which Farmer Mac has carried nonperforming loans on average throughout its history. The LLRT is the weighted average time in fractions of 1 year that Farmer Mac has carried nonperforming loans from the date of the last interest payment, the Interest Paid-Through Date (ITPD) and the date the loan is finally resolved. This proposed LLRT differs from that proposed in November 2005 in the method used to estimate the LLRT period, as described in detail below.

In the final rule preamble to RBCST Version 2.0 published December 26, 2006, we discussed our intent to review further the scaling factor used to estimate the unpaid premium balance associated with estimated loan loss dollar volume. After further review, we believe that basing the scaling factor on the total current portfolio average relationship between origination loan amount and current outstanding loan amounts, as originally proposed, is more appropriate than basing the scaling factor on that same relationship among the small universe of loans that have been through the default and resolution process historically. Our view is based on the small size of the latter data set. This proposed rule also clarifies the calculation of the LLRT period and incorporates additional information provided by Farmer Mac regarding its actual historical LLRT experience.

With the exception of the 1-year period assumed in the loss-severity rate, the current RBCST under a steady-state scenario requires backfilling of loan loss volume with like assets, without recognizing any of the costs associated with carrying loans as non-earning, but funded, assets. Under the proposed rule, the RBCST would reflect additional costs associated with carrying the unpaid principal balance of nonperforming loans during the portion of the LLRT period that exceeds the 1-year assumption.

The change would be incorporated into the RBCST as follows. Off-balance sheet loans with estimated losses are assumed to be purchased from the off-balance sheet portfolio and fully funded at the short-term cost of funds rate used in the model, and any associated guarantee fee income is reversed. The short-term cost of funds (adjusted to incorporate interest rate shock effects) is used to estimate this additional funding cost in recognition of Farmer Mac's actual business practices. On-balance sheet loans generating losses are also removed from the interest earnings calculations and continue to generate interest expense at the blended cost of long- and short-term funds for the

⁵ 66 FR 47730, 47777 (September 13, 2001).

portion of the LLRT period that exceeds 1 year. In response to a comment on the original proposed rule, the rates are not adjusted to incorporate interest rate shock effects in this proposed rule, in contrast to the original proposal of this revision, in recognition that these rates would be in place at the time of the onset of the stress. The model would continue to backfill new loans at the point of loan resolution to retain its steady-state specification.

The proposed revisions involve two principal changes from the current RBCST. First, the date of backfill would be moved to a point in time that more accurately reflects Farmer Mac's actual experience. The model would then capture the additional costs of carrying loans in a non-interest earning category on the balance sheet. Second, the guarantee fee income would be reduced by the weighted average guarantee fee in the portfolio multiplied by the relevant off-balance sheet loan volume over the portion of the LLRT period that exceeds one year. The LLRT would become a data input to be updated with each quarterly submission of the model.

When we first proposed to revise this component in November 2005, we received several comments that noted the need for greater clarity in the LLRT's calculation formula. We have attempted to provide greater clarity in the proposed LLRT calculation as follows:

(1) Assemble in a spreadsheet individual loan level data for all historical nonperforming loans that migrated from the program loan portfolio into nonaccrual status. Identify the "resolution type," i.e., whether the loan resolved by the borrower bringing the loan current or paying off the loan in full, or whether the loan was foreclosed and liquidated prior to being placed in real estate owned (REO), or placed in REO. For each of these resolution types, include the associated dates (e.g., the date the loan was brought current, paid off, liquidated prior to REO, or placed in REO);

(2) Include the following data elements:

Loan Number
 Origination Date
 Original Balance
 Payment Frequency
 Interest Paid Through Date (ITPD)
 Non-Accrual Date
 Unpaid Principal Balance (UPB) at Non-Accrual Date
 Accrued Interest Through Non-Accrual Date
 Resolution-type Code (assign numerical code to each type listed in the paragraph above)
 Resolution Date
 Net Gain/Loss Amount

(3) Remove loan records with missing data elements in "(2)" above from the database for purposes of the LLRT calculation;

(4) Calculate the number of days between the ITPD and the Resolution Date for each loan;

(5) Divide that number of days by 365. The quotient is the LLRT for each loan. Calculate

the weighted-average LLRT using weights based on the total obligation at the Non-Accrual Date (Unpaid Principal Balance at Non-Accrual) and input the resulting weighted-average LLRT into the model's Data Inputs worksheet.

(6) For nonperforming loans that have not resolved, include these loans in the calculation using the quarter end "as of" date of each model submission in place of the resolution date, but include them only if the calculated time interval to the "as of" date is longer than the calculated average LLRT when these records are excluded. In other words, if the carrying time interval is not longer than the calculated LLRT using the data set excluding these records, the records should be excluded from the final LLRT calculation. This will prevent loan records that have not gone completely through the resolution process from exerting a downward influence on the LLRT but allow them to have an upward influence if the unresolved loans' LLRTs are greater than the calculated average before inclusion of such loans.

Farmer Mac commented on our November 2005 proposal that the application of funding rates to the calculation of the carrying cost of nonperforming loans is inconsistent with its actual practice and that the proposed change should be withdrawn. Farmer Mac's comment focused on three aspects of the proposed LLRT change. We will summarize those three and then provide a discussion of each with our response. In this discussion, we refer to liabilities due in 1 year or less as short-term liabilities and to liabilities due after 1 year as "long-term" debt. The comment's three points were: (a) Farmer Mac does not fund nonperforming loans using a certain tenor of debt with perfect consistency, (b) Farmer Mac can effectively change the cost of funds of any nonperforming on-balance sheet loan by employing a "cross-funding" strategy, and (c) the model should not fund on-balance sheet, nonperforming loans at the shocked interest rates under the interest rate risk stress component in the model because these loans would, by having been on the balance sheet at the point in time when rates are shocked, have already been funded at pre-shock rates.

Farmer Mac acknowledged that purchases of nonperforming, off-balance sheet loans would be done at short-term rates in the preponderance of cases, which is consistent with this proposed rule. However, Farmer Mac stated that, in actual practice, it uses a mix of short- and long-term debt because it decides on the appropriate funding term for such purchases based on the existing yield curve conditions and REO disposition expectations. While we accept the premise that in certain cases Farmer Mac might fund such purchases using longer term debt, we believe these

cases are likely to be rare exceptions (e.g., steeply inverted yield curves) and do not create a sufficiently compelling reason to add more complexity to the model such as, for example, a new data input for average off-balance sheet nonperforming loan funding rates. Therefore, we made no change to this specific aspect of the model in this proposed rule.

Farmer Mac commented that it could employ a cross-funding strategy to effectively fund on-balance sheet nonperforming loans at the short-term debt rates such as it uses in most cases of purchases of off-balance sheet nonperforming loans. While we agree that such opportunities could occur, we believe that assuming that Farmer Mac would always have the opportunity to purchase new program assets with the same size and expected life characteristics as on-balance sheet nonperforming loans is too broad an assumption to incorporate into the model. While it is possible that Farmer Mac could execute a similar rebalancing and reassignment of debt tenors among its program assets by adjustments to its ongoing daily funding selections, we would also view such a potentially complex incorporation of this contingent scenario into the model as unjustified for the added level of accuracy it might provide in certain cases. Therefore, we have made no change to the funding rates applied to calculate carrying cost of on-balance sheet nonperforming loans in this proposed rule.

Finally, Farmer Mac commented that the model should not fund on-balance sheet, nonperforming loans at shocked interest rate levels established by statute because these loans would, by having been already on the balance sheet at the point in time when rates are shocked, have been funded at pre-shocked rates. We agree with the comment and have revised the cost of funds applied to on-balance sheet nonperforming loans during the LLRT to pre-shock blended long- and short-term cost of funds rates in this proposed rule.

The proposed LLRT revisions are forward-looking only. In other words, actual loans that defaulted in year zero and are in their second year of nonperforming status in year one of the model's 10-year time horizon are not included in the proposed LLRT revision, and therefore no adjustment to restate current balance sheet amounts is needed. We considered an approach involving such a restatement but rejected it as unnecessarily complex. We note that our proposed revision to more accurately reflect the carrying cost of nonperforming loans results in less

additional stress in a down-rate interest rate risk environment. This result is appropriate, as it would be less costly to fund nonperforming loans when interest rates are relatively low.

We propose one further adjustment to complete the LLRT revision. The RBCST is sometimes referred to as an "origination loan model" because it performs its loss estimation based on origination loan amounts and dates. The model does not incorporate loan interest rates or amortization of the loan portfolio. However, implementation of the LLRT revision would require us to make an estimate of loan amortization because it would be inaccurate to estimate the additional carrying cost associated with the LLRT period by applying the appropriate cost of funds to a loan's origination amount. We propose to use the portfolio average principal amortization to make this adjustment (i.e., total portfolio current scheduled principal balance divided by total origination balance). We would also incorporate into the blended rate

used to calculate the carrying cost of nonperforming on-balance sheet loans an increment of interest expense associated swap expense according to Farmer Mac's practice of combining debt and swap contracts to fund loans.

E. Technical Changes to Improve Formatting and Clarity of Cell Labeling and Submission Deadlines

In the RBCST spreadsheet, we have relocated the quarter-end date selection pull-down menu from the Assumptions and Relationships page to the Capital worksheet for convenience. We have also made line item labeling changes to enhance clarity in both the CLM and the RBC modules. We have also revised § 652.85 to update submission deadlines to be the same as the filing deadlines of Farmer Mac's public disclosures on Forms 10-Q and 10-K required by the Securities and Exchange Commission.

IV. Impact of Proposed Changes on Required Capital

We have evaluated the impact of the proposed changes to the currently active

version of the model, Version 2.0. Our tests indicate that changes related to the LLRT would have the most significant impact on risk-based capital calculated by the model. The table below provides an indication of the impact of the revisions in the quarter ended March 31, 2007. The lines labeled "General Obligation Adjustment", "Investment Haircuts", and "Carrying Costs of Nonperforming Loans" present the impacts if only that revision were made to the current version, and the column labeled "Difference" calculates the impact of that individual change for the quarter ended March 31, 2007, compared to the requirement calculated using the currently active Version 2.0. The bottom line presents the impact of all proposed revisions in Version 3.0. As the table shows, the individual estimated impacts do not have an additive relationship to the total impact on the model output. This is due to the interrelationship of the changes with one another when they are combined in Version 3.0.

Calculated regulatory capital (\$ in thousands)	3/31/2007	Difference
RBCST Version 2.0	80,831
Treatment of Loans Backed by an Obligation of the Counterparty and Contractually Required Overcollateral	73,244	- 7,587
Investment Haircuts	83,922	3,091
Carrying Cost of Nonperforming Loans	105,170	24,340
RBCST Version 3.0 Change Impacts	100,079	19,249

V. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), FCA hereby certifies the rule will not have a significant economic impact on a substantial number of small entities. Farmer Mac has assets and annual income over the amounts that would qualify it as a small entity. Therefore, Farmer Mac is not considered a "small entity" as defined in the Regulatory Flexibility Act.

List of Subjects in 12 CFR Part 652

Agriculture, Banks, banking, Capital, Investments, Rural areas.

For the reasons stated in the preamble, part 652 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended to read as follows:

PART 652—FEDERAL AGRICULTURAL MORTGAGE CORPORATION FUNDING AND FISCAL AFFAIRS

1. The authority citation for part 652 continues to read as follows:

Authority: Secs. 4.12, 5.9, 5.17, 8.11, 8.31, 8.32, 8.33, 8.34, 8.35, 8.36, 8.37, 8.41 of the Farm Credit Act (12 U.S.C. 2183, 2243, 2252,

2279aa-11, 2279bb, 2279bb-1, 2279bb-2, 2279bb-3, 2279bb-4, 2279bb-5, 2279bb-6, 2279cc); sec. 514 of Pub. L. 102-552, 106 Stat. 4102; sec. 118 of Pub. L. 104-105, 110 Stat. 168.

Subpart B—Risk-Based Capital Requirements

2. Amend § 652.65 by redesignating paragraph (b)(5) as new paragraph (b)(6) and adding a new paragraph (b)(5) to read as follows:

§ 652.65 Risk-based capital stress test.

* * * * *

(b) * * *

(5) You will further adjust losses for loans that collateralize the general obligation of Off-Balance Sheet AgVantage volume, and for loans where the program loan counterparty retains a subordinated interest in accordance with Appendix A to this subpart.

* * * * *

3. Amend § 652.85 by revising paragraph (d) to read as follows:

§ 652.85 When to report the risk-based capital level.

* * * * *

(d) You must submit your quarterly risk-based capital report for the last day of the preceding quarter by the earlier of the reporting deadlines for Securities and Exchange Commission Forms 10-K and 10-Q, or the 40th day after each of the quarter's ending March 31st, June 30th, and September 30th, and the 75th day after the quarter ending on December 31st.

4. Appendix A of subpart B, part 652 is amended by:

- a. Revising the table of contents;
- b. Revising the first and second sentences of section 2.0;
- c. Redesignating existing section 2.4 as new section 2.5;
- d. Adding a new section 2.4;
- e. Revising section 4.1 e.;
- f. Revising the last sentence of section 4.2 b.(3) introductory text;
- g. Redesignating existing section 4.2 b.(3)(C) and (D) as new paragraph (3)(F) and (G);
- h. Adding new section 4.2 b. (3)(C), (D), and (E);
- i. Revising section 4.4;
- j. Revising section 4.5 a.;
- k. Removing the word "unretained" and adding in its place, the word

“retained” in the ninth sentence of section 4.6 b.

Appendix A—Subpart B of Part 652—Risk-Based Capital Stress Test

- 1.0 Introduction.
- 2.0 Credit Risk.
- 2.1 Loss-Frequency and Loss-Severity Models.
- 2.2 Loan-Seasoning Adjustment.
- 2.3 Example Calculation of Dollar Loss on One Loan.
- 2.4 Treatment of Loans Backed by an Obligation of the Counterparty and Loans for which Pledged Loan Collateral Volume Exceeds Farmer Mac-Guaranteed Volume.
- 2.5 Calculation of Loss Rates for Use in the Stress Test.
- 3.0 Interest Rate Risk.
- 3.1 Process for Calculating the Interest Rate Movement.
- 4.0 Elements Used in Generating Cashflows.
- 4.1 Data Inputs.
- 4.2 Assumptions and Relationships.
- 4.3 Risk Measures.
- 4.4 Loan and Cashflow Accounts.
- 4.5 Income Statements.
- 4.6 Balance Sheets.
- 4.7 Capital.

- 5.0 Capital Calculations.
- 5.1 Method of Calculation.

2.0 Credit Risk.

Loan loss rates are determined by applying the loss-frequency equation and the loss-severity factor to Farmer Mac loan-level data. Using this equation and severity factor, you must calculate loan losses under stressful economic conditions assuming Farmer Mac’s portfolio remains at a “steady state.” * * *

2.4 Treatment of Loans Backed by an Obligation of the Counterparty, and Loans for which Pledged Loan Collateral Volume Exceeds Farmer Mac-Guaranteed Volume.

You must calculate the age-adjusted loss rates for these loans that includes adjustments to scale losses according to the proportion of total submitted collateral to the guaranteed amount as provided for in the “Dollar Losses” column of the transformed worksheets in the Credit Loss Module based on new data inputs required in the “Coefficients” worksheet of the Credit Loss Module. Then, you must adjust the calculated loss rates as follows.

a. For loans in which the seller retains a subordinated interest, subtract from the total

estimated age-adjusted dollar losses on the pool the amount equal to current unpaid principal times the subordinated interest percentage.

b. Some pools of loans underlying specific transactions could include loan collateral volume pledged to Farmer Mac in excess of Farmer Mac’s guarantee amount (“overcollateral”). Overcollateral can be either: (i) Contractually required according to the terms of the transaction, or (ii) not contractually required, but pledged in addition to the contractually required amount at the discretion of the counterparty, often for purposes of administrative convenience regarding the collateral substitution process, or (iii) both (i) and (ii).

1. If a pool of loans includes collateral pledged in excess of the guaranteed amount, you must adjust the age-adjusted, loan-level dollar losses by a factor equal to the ratio of the guarantee amount to total submitted collateral. For example, consider a pool of two loans serving as security for a Farmer Mac guarantee on a note with a total issuance face value of \$2 million and on which the counterparty has submitted 10-percent overcollateral. The two loans in the example have the following characteristics and adjustments.

Loan	Origination balance	Age-adjusted loss rate (percent)	Estimated age-adjusted losses	Guarantee amount scaling adjustment (2/2.2) (percent)	Losses adjusted for overcollateral
1	\$1,080,000	7.0	\$75,600	90.91	\$68,727
2	1,120,000	5.0	56,000	90.91	50,909

2. If a pool of loans includes collateral pledged in excess of the guaranteed amount that is required under the terms of the transaction, you must further adjust the dollar losses as follows. Calculate the total losses on the subject portfolio of loans after age adjustments and any adjustments related to total submitted overcollateral as described in “1.” above. Calculate the total dollar amount of contractually required overcollateral in the subject pool. Subtract the total dollars of contractually required overcollateral from the adjusted total losses on the subject pool. If the result is less than

or equal to zero, input a loss rate of zero for this transaction pool in the Data Inputs worksheet of the RBCST. A new category must be created for each such transaction in the RBCST. If the loss rate after subtracting contractually required overcollateral is greater than zero, proceed to additional adjustment for the risk-reducing effects of the counterparty’s general obligation described in “3.” below.

3. Loans with a positive loss estimate remaining after adjustments in “1.” and “2.” above, are further adjusted for the security provided by the general obligation of the

counterparty. To make this adjustment, multiply the estimated dollar losses remaining after adjustments in “1.” and “2.” above by the appropriate general obligation adjustment factor based on the counterparty’s whole-letter issuer credit rating by a nationally recognized statistical rating organization (NRSRO).

The following table sets forth the general obligation adjustment factors and their components by whole-letter credit rating (Adjustment Factor = Default Rate x Severity Rate).¹⁵

Whole-letter rating	Default rate (percent)	Severity rate (percent)	General obligation adjustment factor (percent)
AAA	0.89	55	0.49
AA	2.31	55	1.26
A	2.90	55	1.58
BBB	7.29	55	3.98
Below BBB and Unrated	27.39	55	15.16

The adjustment factors will be updated annually as Moody’s annual report on

Default and Recovery Rates of Corporate Bond Issuers becomes available, normally in

January or February of each year. In the event that there is an interruption of Moody’s

¹⁵ Hamilton, D., Ou S., Kim R., Cantor R., “Corporate Default and Recovery Rates, 1920–2006,” published by Moody’s Investors Service,

February 2007—the most recent edition as of April 2007; Default Rates, page 22, Recovery Rates

(Severity Rate = 1 minus Senior Unsecured Average Recovery Rate) page 18.

publication of this annual report, or FCA determines that the format of the report has changed enough to prevent or call into question the identification of updated factors, the prior year's factors will remain in effect until FCA revises the process through rulemaking.

4. Continuing the previous example, the pool contains two loans on which Farmer Mac is guaranteeing a total of \$2 million and with total submitted collateral of 110 percent of the guaranteed amount. Of the 10-percent total overcollateral, 5 percent is contractually required under the terms of the transaction. The pool consists of two loans of slightly

over \$1 million. Total overcollateral is \$200,000, of which \$100,000 is contractually required. The counterparty has a single "A" credit rating, and after adjusting for contractually required overcollateral, estimated losses are greater than zero. The net loss rate is calculated as described in the steps in the table below.

		Loan A	Loan B
1	Guaranteed Volume	\$2,000,000	
2	Origination Balance of 2-Loan Portfolio	\$1,080,000	\$1,120,000
3	Age-adjusted Loss Rate	7%	5%
4	Estimated Age-adjusted Losses	\$75,600	\$56,000
5	Guarantee Volume Scaling Factor	90.91%	90.91%
6	Losses Adjusted for Total Overcollateral	\$68,727	\$50,909
7	Contractually required Overcollateral on Pool (5%)	\$100,000	
8	Net Losses on Pool Adjusted for Contractually Required Overcollateral	\$19,636	
9	General Obligation Adjustment Factor for "A" Issuer	1.58%	
10	Losses Adjusted for "A" General Obligation	\$310	
11	Loss Rate Input in the RBCST for this Pool	0.02%	

The net, fully adjusted losses are distributed over time on a straight-line basis. When a transaction reaches maturity within the 10-year modeling horizon, the losses are distributed on a straightline over a timepath that ends in the year of the transaction's maturity.

* * * * *

4.1 Data Inputs.

* * * * *

e. *Weighted Haircuts for Non-Program Investments.* For non-program investments, the stress test adjusts the weighted average yield data referenced in section 4.1 b. to reflect counterparty risk. Non-program investments are defined in § 652.5. The Corporation must calculate the haircut to be applied to each investment based on the lowest whole-letter credit rating the investment received from a NRSRO using the haircut levels in the following two tables.

The first table provides the mappings of NRSRO ratings to whole-letter ratings for purposes of applying haircuts. Any "+" or "-" signs appended to NRSRO ratings that are not shown in the table should be ignored for purposes of mapping NRSRO ratings to FCA whole-letter ratings. The second table provides the haircut levels by whole-letter rating category.

FCA WHOLE-LETTER CREDIT RATINGS MAPPED TO RATING AGENCY CREDIT RATINGS

FCA Ratings Category	AAA	AA	A	BBB	Below BBB and Unrated.
Standard & Poor's Long-Term	AAA	AA	A	BBB	Below BBB and Unrated.
Fitch Long-Term	AAA	AA	A	BBB	Below BBB and Unrated.
Moody's Long-Term	Aaa	Aa	A	Baa	Below Baa and Unrated.
Standard & Poor's Short-Term	A-1+	A-1	A-2	A-3	SP-3, B, or Below and Unrated.
Fitch Short-Term	SP-1+	SP-1	SP-2		
Moody's	F-1+	F-1	F-2	F-3	Below F-3 and Unrated.
		Prime-1 ...	Prime-2 ...	Prime-3 ...	Not Prime, SG and Unrated.
		MIG1	MIG2	MIG3	
		VMIG1	VMIG2	VMIG3	
Fitch Bank Ratings	A	B	C	D	E
		A/B	B/C	C/D	D/E.
Moody's Bank Financial Strength Rating	A	B	C	D	E.

FARMER MAC RBCST MAXIMUM HAIRCUT BY RATINGS CLASSIFICATION

Ratings classification	Non-program investment counterparties (excluding derivatives) (percent)
Cash	0.00
AAA	0.49
AA	1.26
A	1.58
BBB	3.98
Below BBB and Unrated	15.16

Certain special cases will receive the following treatment. For an investment structured as a collateralized obligation backed by the issuer's general obligation and, in turn, a pool of collateral, reference the

Issuer Rating or Financial Strength Rating of that issuer as the credit rating applicable to the security. Unrated securities that are fully guaranteed by Government-sponsored enterprises (GSE) such as the Federal National Mortgage Corporation (Fannie Mae) will receive the same treatment as AAA securities. Unrated securities backed by the full faith and credit of the U.S. Government will not receive a haircut.

If FCA approves the purchase of an unrated investment, and portions of that investment are later sold by Farmer Mac according to their specific risk characteristics, the Director will take reasonable measures to adjust the haircut level applied to the investment to recognize the change in the risk characteristics of the retained portion. The Director will consider similar methods for dealing with capital requirements adopted by other Federal financial institution regulators in similar situations.

Individual investment haircuts must then be aggregated into weighted-average haircuts by investment category and submitted in the "Data Inputs" worksheet. The spreadsheet uses these inputs to reduce the weighted-average yield on the investment category to account for counterparty insolvency according to a 10-year linear phase-in of the haircuts. Each asset account category identified in this data requirement is discussed in section 4.2, "Assumptions and Relationships."

* * * * *

4.2 Assumptions and Relationships

* * * * *

b. * * *

(3) *Elements related to income and expense assumptions.* * * * These parameters are the gain on agricultural mortgage-backed securities (AMBS) sales, miscellaneous income, operating expenses, reserve

requirement, guarantee fees and loan loss resolution timing.

* * * * *

(C) The stress test assumes that short-term cost of funds is incurred in relation to the amount of defaulting loans purchased from off-balance sheet pools. The remaining unpaid principal balance on this loan volume is the origination amount reduced by the proportion of the total portfolio that has amortized as of the end of the most recent quarter. This volume is assumed to be funded at the short-term cost of funds and this expense continues for a period equal to the loan loss resolution timing period (LLRT) period minus 1. We will calculate the LLRT period from Farmer Mac data. In addition, during the LLRT period, all guarantee income associated with the loan volume ceases.

(D) The stress test generates no interest income on the estimated volume of defaulted on-balance sheet loan volume required to be carried during the LLRT period, but continues to accrue funding costs during the remainder of the LLRT period.

(E) You must update the LLRT period in response to changes in the Corporation's actual experience with each quarterly submission.

* * * * *

4.4 Loan and Cashflow Accounts

The worksheet labeled "Loan and Cashflow Data" contains the categorized loan data and cashflow accounting relationships that are used in the stress test to generate projections of Farmer Mac's performance and condition. As can be seen in the worksheet, the steady-state formulation results in account balances that remain constant except for the effects of discontinued programs, maturing Off-Balance Sheet AgVantage positions, and the LLRT adjustment. For assets with maturities under 1 year, the results are reported for convenience as though they matured only one time per year with the additional convention that the earnings/cost rates are annualized. For the pre-1996 Act assets, maturing balances are added back to post-1996 Act account balances. The liability accounts are used to satisfy the accounting identity, which requires assets to equal liabilities plus owner equity. In addition to the replacement of maturities under a steady state, liabilities are increased to reflect net losses or decreased to reflect resulting net gains. Adjustments must be made to the long- and short-term debt accounts to maintain the same relative proportions as existed at the beginning period from which the stress test is run with the exception of changes associated with the funding of defaulted loans during the LLRT period. The primary receivable and payable accounts are also maintained on this worksheet, as is a summary balance of the volume of loans subject to credit losses.

4.5 Income Statements

a. Information related to income performance through time is contained on the worksheet named "Income Statements." Information from the first period balance sheet is used in conjunction with the earnings and cost-spread relationships from Farmer Mac supplied data to generate the

first period's income statement. The same set of accounts is maintained in this worksheet as "Loan and Cashflow Accounts" for consistency in reporting each annual period of the 10-year stress period of the test with the exception of the line item labeled "Interest reversals to carry loan losses" which incorporates the LLRT adjustment to earnings from the "Risk Measures" worksheet. Loans that defaulted do not earn interest or guarantee any commitment fees during LLRT period. The income from each interest-bearing account is calculated, as are costs of interest-bearing liabilities. In each case, these entries are the associated interest rate for that period multiplied by the account balances.

Dated: September 7, 2007.

Roland E. Smith,

Secretary, Farm Credit Administration Board.

[FR Doc. E7-18014 Filed 9-12-07; 8:45 am]

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA-2007-29170; Directorate Identifier 2007-NM-075-AD]

RIN 2120-AA64

Airworthiness Directives; Airbus Model A319 and A320 Series Airplanes

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: We propose to adopt a new airworthiness directive (AD) for the products listed above. This proposed AD results from mandatory continuing airworthiness information (MCAI) originated by an aviation authority of another country to identify and correct an unsafe condition on an aviation product. The MCAI describes the unsafe condition as:

Some taperlocks used in the wing-to-fuselage junction at rib 1 were found to be non-compliant with the applicable specification, resulting in a loss of pre-tension in the fasteners. In such conditions, the structural integrity of the aircraft could be affected.

The proposed AD would require actions that are intended to address the unsafe condition described in the MCAI.

DATES: We must receive comments on this proposed AD by October 15, 2007.

ADDRESSES: You may send comments by any of the following methods:

- *DOT Docket Web Site:* Go to <http://dms.dot.gov> and follow the instructions for sending your comments electronically.

- *Fax:* (202) 493-2251.

- *Mail:* U.S. Department of

Transportation, Docket Operations, M-30, West Building Ground Floor, Room W12-140, 1200 New Jersey Avenue SE., Washington, DC 20590.

- *Hand Delivery:* Room W12-140 on the ground floor of the West Building, 1200 New Jersey Avenue SE., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

Examining the AD Docket

You may examine the AD docket on the Internet at <http://dms.dot.gov>; or in person at the Docket Operations office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this proposed AD, the regulatory evaluation, any comments received, and other information. The street address for the Docket Operations office (telephone (800) 647-5527) is in the **ADDRESSES** section. Comments will be available in the AD docket shortly after receipt.

FOR FURTHER INFORMATION CONTACT: Tim Dulin, Aerospace Engineer, International Branch, ANM-116, FAA, Transport Airplane Directorate, 1601 Lind Avenue SW., Renton, Washington 98057-3356; telephone (425) 227-2141; fax (425) 227-1149.

SUPPLEMENTARY INFORMATION:

Comments Invited

We invite you to send any written relevant data, views, or arguments about this proposed AD. Send your comments to an address listed under the **ADDRESSES** section. Include "Docket No. FAA-2007-29170; Directorate Identifier 2007-NM-075-AD" at the beginning of your comments. We specifically invite comments on the overall regulatory, economic, environmental, and energy aspects of this proposed AD. We will consider all comments received by the closing date and may amend this proposed AD based on those comments.

We will post all comments we receive, without change, to <http://dms.dot.gov>, including any personal information you provide. We will also post a report summarizing each substantive verbal contact we receive about this proposed AD.

Discussion

The European Aviation Safety Agency (EASA), which is the Technical Agent for the Member States of the European Community, has issued EASA Airworthiness Directive 2007-0067R1, dated June 7, 2007 (referred to after this