BL-007 (Original # 245-OFA)
Disclosure of Financial Forecasts

March 2, 1990

To: The Chief Executive Officer
All Farm Credit System Institutions

From: Michael J. Powers, Director
Office of Financial Analysis

Subject: Disclosure of Financial Forecasts

Background

Since enactment of the Agricultural Credit Act of 1987, several Farm Credit (FC) institutions have expressed their desire to include prospective financial statements in stockholder disclosures associated with corporate restructuring proposals. Since a majority of the restructuring proposals developed under Title VII of the Farm Credit Act of 1971, as amended (Act), will have a significant impact on the future operations, financial strength, and capital adequacy of the constituent institutions involved, the Farm Credit Administration (FCA) agrees that disclosure of prospective financial information as a part of the disclosure materials would provide important information relevant to the stockholders' voting decision.

Disclosure of Financial Forecasts to Stockholders

The FCA encourages FC institutions to disclose financial forecasts to stockholders when submitting corporate restructuring proposals to stockholders pursuant to Title VII of the Act, provided that the disclosure complies with the guidelines contained in Accounting Bulletin No. 90-1 "Disclosure of Prospective Financial Statements to Stockholders" (Attachment A). The accounting bulletin requires the disclosure be made in accordance with the "Guide for Prospective Financial Statements" issued by the American Institute of Certified Public Accountants (AICPA Guide). The accounting bulletin is effective immediately. Also attached is a checklist for presentation and disclosure of financial forecasts to stockholders (Attachment B). The checklist is based on the AICPA Guide.

Disclosure of Financial Forecasts to the FCA

Financial forecasts prepared solely for use by the FCA in support of an institution's restructuring proposal will be regarded as limited use financial forecasts. While we encourage FC institutions to disclose financial forecasts to stockholders in accordance with the AICPA Guide, at a minimum, the FCA requires FC institutions to file a limited use financial forecast at the time the FCA's approval of a restructuring proposal is requested. In so doing, FC institutions should follow the FCA guidelines established in its bookletter(s) and letters to FC institutions containing the instructions for submission of restructuring proposals to the FCA. Such limited use financial forecasts should not be disclosed to stockholders.

For filing of limited use financial forecasts with the FCA, FC institution should, at a minimum, include: (1) dividers that clearly separate the limited use financial forecasts from the disclosure documents to be submitted to stockholders; (2) prospective financial statements of the resulting entity of the restructuring proposal, i.e., balance sheet and income statement, covering at least 3 years of future operations in addition to the current year (full year) financial statements; (3) permanent capital ratios for the forecast period; and (4) summaries of significant assumptions used to develop the forecast and accounting policies.

Financial assumptions may be disclosed in computer printout or electronic spreadsheets, and disclosure of accounting policies may be accomplished by cross-referencing to the information contained elsewhere in the documents submitted. The FCA may require additional information to support the reasonableness of the assumptions used in the forecast or "what if" scenarios, e.g., the best and/or the worse cases, as considered necessary.

Guidelines for Disclosure of Forecasts to Stockholders vs. Disclosure of Forecasts to the FCA

Financial forecasts prepared for disclosure to stockholders may not be appropriate for filing with the FCA for limited use and vice versa. For instance, while a financial forecast covering 1 full year of operations may be appropriate for disclosure to stockholders, the forecast does not meet the FCA's requirement, i.e., a limited use financial forecast must include at least a 3-year forecast period. We suggest that FC institutions refer to the guidelines contained in the attached checklist for development of limited use financial forecasts. The completed checklist is to be submitted to the FCA regardless of whether the forecast is to be disclosed to stockholders or to the FCA only.

Please direct any inquiries regarding this letter to the Financial Analysis and Standards Division at (703) 883-4475.

Attachments

Accounting Bulletin 90-1
Attachment A

Subject: Disclosure of Prospective Financial Statements to Stockholders

Statement of Accounting Policy

Farm Credit Administration (FCA) Regulation 621.3(b) requires each institution of the Farm Credit System to "Prepare its financial statements and reports, . . . in accordance with generally accepted accounting principles, except as otherwise directed by statutory and regulatory requirements or otherwise required by the Farm Credit Administration." Though FCA regulations do not require disclosure of a financial forecast to stockholders when submitting a restructuring proposal to stockholders for voting, the FCA encourages Farm Credit (FC) institutions to disclose financial forecasts to stockholders, provided that management has a reasonable basis for a forecast and the forecast is prepared and presented in accordance with the "Guide for Prospective Financial Statements" issued by the American Institute of Certified Public Accountants (AICPA Guide). In addition, financial forecasts to be disclosed to stockholders may, but are not required to, include an outside reviewer's report, provided such report includes a disclosure of the reviewer's qualifications, the relationship of the reviewer to the issuing institution, and the extent of the review.

Application of the Accounting Policy

This accounting bulletin is effective immediately and applies to all FC institutions' prospective financial statements disclosed to stockholders in conjunction with corporate restructuring proposals submitted to stockholders under Title VII of the Farm Credit Act of 1971, as amended (Act).

Background

The Agricultural Credit Act of 1987 provided additional alternatives to the FC institutions for corporate restructurings. A majority of the proposals developed under the restructuring provisions (Title VII) of the Act will have a significant impact on the operations, financial strength, and capital adequacy of the constituent institutions involved. In order to provide meaningful information to stockholders such that they may make an informed decision, several institutions have expressed their desire to include prospective financial statements in their disclosure to stockholders. The FCA agrees that disclosure of prospective financial information would be beneficial to stockholders and, therefore, issues guidance to permit the institutions to disclose financial forecasts, on a voluntary basis, to stockholders for restructuring proposals developed under Title VII of the Act.

Please direct any inquiries regarding this accounting bulletin to the Financial Analysis and Standards Division at (703) 883-4475.

John C. Moore, Jr., Deputy Chief
Financial Analysis and Standards Division Date: March 2, 1990

Attachment B

Presentation and Disclosure of Financial Forecasts to Stockholders in Accordance with the AICPA Guide for Prospective Financial Statements

____
(Name of the Reporting Entity)

GENERAL INFORMATION

1. Disclosure of Financial Forecasts to Stockholders

   a. Farm Credit institutions (FCIs) may disclose prospective financial statements (PFS) to stockholders, provided that the preparation and presentation of the PFS meets the requirements of the "Guide for Prospective Financial Statements" issued by the American Institute of Certified Public Accountants (AICPA Guide). Financial forecasts that are prepared for general use may be presented to stockholders. Financial projections and partial presentations should not be disclosed to stockholders, unless these presentations are included in a financial forecast as a supplement to the forecast.

   b. This checklist includes the presentation and disclosure requirements for financial forecasts set forth in the AICPA Guide. References to the paragraph numbers of the AICPA Guide and other authoritative literature are cited for each line item.

   c. The items with an asterisk (*) at the end of the question represent additional items the FCA believes are necessary to adapt the AICPA Guide to adequately portray the prospective operation of FCIs. FCIs' presentations of financial forecasts should meet the minimum presentation guidelines detailed in the AICPA Guide and include additional information required by the FCA.

   d. Use of the "Comments" section on the last page of the checklist to bring unusual matters to the attention of the FCA.

2. **Import Terms**—The terms used in this checklist have the same meaning as those used in the AICPA Guide.

   a. **Financial forecast—**PFS that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operation, and cash flows.

   b. **Financial projection**—PFS that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operation, and cash flows.

   c. **General use**—Refers to the use of prospective financial statements by persons with whom the responsible party is not negotiating directly, e.g., in an offering statement of an entity's debt or equity interest.

d. **Hypothetical assumption**—An assumption used in a financial projection to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the projection.

e. **Prospective financial statements**—Refers to either financial forecasts or financial projections, including the summaries of significant assumptions and accounting policies. Pro forma financial statements and partial presentations are not considered prospective financial statements.

f. **Partial presentation**—Presentations of prospective financial statements that do not meet the minimum presentation guidelines of the AICPA Guide.

g. **Responsible party**—The person or persons who are responsible for the assumptions underlying the PFS. The responsible party usually is management.

3. **<u>Documentation</u>**—Though the terms "financial forecast" and "financial projection" are defined in the AICPA Guide, it is ambiguous as to what constitutes a forecast or a projection. It is sometimes difficult to determine whether one or more assumptions used to develop the prospective financial statements represents a course of action that is expected to occur or a hypothetical condition. Therefore, each issuing institution must ensure that it maintains appropriate documents to support the reasonableness of the assumptions used in the forecast and such documents shall be subject to review by the FCA.

4. **<u>Submission of Checklist and Financial Forecast</u>**—Each financial forecast submitted to the FCA shall be accompanied by a completed transmittal sheet and the presentation and disclosure checklist.

5. **<u>Evaluation Criteria</u>**—FCA's evaluation and approval of financial forecasts for disclosure to stockholders will be made based upon the requirements set forth in the AICPA Guide. The FCA may require the responsible party to submit additional information to support the reasonableness of the underlying assumptions of the forecast. And upon the request of the FCA, the responsible party must demonstrate to the FCA that the preparation of the institution's forecast meets the following requirements:

   a. Financial forecasts are prepared in good faith.

   b. Financial forecasts are prepared with appropriate care by qualified personnel.

   c. Financial forecasts are prepared using appropriate accounting principles.

   d. The process used to develop financial forecasts provides for seeking out the best information that is reasonably available at the time.

   e. The information used in preparing financial forecasts is consistent with the plans of the entity.

f. Key factors are identified as a basis for assumptions.

g. Assumptions used in preparing financial forecasts are appropriate.

h. The process used to develop financial forecasts provides the means to determine the relative effect of variations in the major underlying assumptions.

i. The process used to develop financial forecasts provides adequate documentation of both the financial forecasts and the process used to develop them.

j. The process used to develop financial forecasts includes, where appropriate, the regular comparison of the financial forecasts with attained results.

k. The process used to prepare financial forecasts includes adequate review and approval by the responsible party at the appropriate levels of authority.

TRANSMITTAL SHEET

Farm Credit District
____

Requested action for which the forecast is prepared: ____

Disclosure of the forecast to stockholders: Yes ____ No ____

Forecast completed by: ___________________ Tel: (___) ______________

Prospective period ending:
____

Completion date of the forecast:
____

Name of the requesting Farm Credit institution(s): ____

CEO Name: ___________________ Telephone: (___)
Street Address:
____

Mailing Address:
____

City, State, Zip:
____

County:
____

CEO Name: ___________________ Telephone: (___)
Street Address:
____

Mailing Address:
____

City, State, Zip:
____

County:
____

CEO Name: ___________________ Telephone: (___)
Street Address:
____

Mailing Address:

City, State, Zip: ___

County: ___

___

CEO Name: ____________________ Telephone: (___)
Street Address: ___

Mailing Address: ___

City, State, Zip: ___

County: ___

___

CHECKLIST

Indicate Y (yes), N (no), or N/A (not applicable). And, if applicable, include the page number or other index number where the information is presented. Explanations must be provided for each question answered with an "N" in the Comments section at the end of the checklist.

TITLE

___ 1. Does the title of the forecast describe the nature of the presentation and include the word "forecast" or "forecasted," e.g., "Forecasted Balance Sheet" or "Statement of Forecasted Income?" (AICPA Guide 400.05)

___ 2. Does the title indicate the prospective period covered and use the word "ending" to indicate its prospective nature, e.g., "Year Ending 199X?" (*)

___ 3. If a historical statement also is presented, does the title indicate the historical presentation and describe the period covered with the word "ended," e.g., "Year Ending December 31, 19X1 (Forecasted), and Year Ended December 31, 19X0 (Historical)?" (*)

PRESENTATION

___ 4. If a forecast and a projection (included as a supplement to the forecast) are presented together, or if prospective and historical information are presented together, is each column clearly labeled? (Note: For general use, a projection may supplement a forecast provided it does not extend beyond the forecast period.) (AICPA Guide 210.05, 400.20, and 400.34)

___ 5. If a presentation of a financial forecast is made for other than a single-point estimate (i.e., as a range), is there a clear indication that the presentation does not necessarily represent the best or worst possible alternatives? (AICPA Guide 400.21)

___ 6. Does the presentation cover at least one full year of normal operations? (AICPA Guide 400.32)

___ 7. If long-term results are important to the presentation: (AICPA Guide 400.33)

  ___ a. have enough future periods been presented to demonstrate the long-term results, or

  ___ b. if not practical, does the presentation include a description of the potential effect of such results?

___ 8. If there is a significant start-up period, has it been presented separately? (AICPA Guide 400.32)

___ 9. Have the name, form, and equity components of an entity yet to be formed been disclosed (or if they have not been decided, has that fact been disclosed)? (AICPA Guide 400.32)

___ 10. Are the following minimum financial statement elements disclosed (this requirement would be met if these items can be derived from the financial statements or the notes): (AICPA Guide 400.06)

___ a. interest income and gross loan volume?

___ b. interest expense or net interest margin?

___ c. allowance for loan losses and provision for loan losses? (*)

___ d. unusual or infrequently occurring items?

___ e. other operating expenses? (*)

___ f. provision for income taxes?

___ g. extraordinary items?

___ h. income before taxes?

___ i. net income?

___ j. permanent capital ratio? (*)

___ k. significant changes in cash flows?

___ l. significant changes in permanent capital? (*)

DISCLOSURE ON FACE OF STATEMENTS

___ 11. Does each page of the presentation contain a reference such as "See accompanying summaries of significant assumptions and accounting policies?" (AICPA Guide 400.10)

___ 12. Is a summary of significant assumptions presented? (AICPA Guide 400.22)

ASSUMPTIONS

___ 13. Is the basis or rationale for the assumptions disclosed? (AICPA Guide 400.22)

___ 14. Is there an introduction to the summary of assumptions that does the following:

___ a. indicates the assumptions disclosed are not all-inclusive? (AICPA Guide 400.28)

___ b. states that the assumptions were based on the responsible party's judgment at the time the prospective information was prepared? (AICPA Guide 400.28)

___ c. describes what the presentation is intended to present? (AICPA Guide 400.28)

___ d. indicates the date of preparation of the presentation? (AICPA Guide 400.11)

___ e. includes a caveat that the prospective results may not be attained?

___ f. includes a statement that the responsible party does not intend to update the presentation (optional)? (AICPA Guide 400.38)

___ g. if the presentation is a range, includes a statement that the responsible party expects the results to fall within the range although there can be no assurance that they will? (AICPA Guide 400.30)

___ 15. Are the following types of assumptions disclosed:

___ a. particularly sensitive assumptions, noting that they are particularly sensitive? (AICPA Guide 400.24)

___ b. assumptions about anticipated conditions, if there is a reasonable possibility that they will be significantly different from current conditions, if not reasonably apparent? (AICPA Guide 400.23)

___ c. significant implicit assumptions that current conditions will prevail, e.g., continued absence of war, natural disasters, and so on (disclosure is needed only if there is a reasonable possibility that the current conditions will not prevail)? (AICPA Guide 400.26)

___ d. other significant matters deemed important? (AICPA Guide 400.23)

___ 16. Are hypothetical assumptions in a projection disclosed and identified as hypothetical? (if applicable, see item No. 4) (AICPA Guide 400.23P)

___ 17. Is there an indication of which hypothetical assumptions, if any, are improbable? (if applicable, see item No. 4) (AICPA Guide 400.23P)

___ 18. If an updated prospective presentation is issued, is the reason for updating disclosed in the summary of significant assumptions? (AICPA Guide 400.38)

<u>ACCOUNTING PRINCIPLES AND POLICIES</u>

___ 19. Are significant accounting policies disclosed? (AICPA Guide 400.12)

___ 20. Is the prospective presentation prepared on the same basis of accounting expected to be used for the historical financial statements? (AICPA Guide 400.15)

If not:

___ a. Are the results of operations and cash flows in the prospective presentation reconciled with the results that would have been obtained using the basis for historical statements? or

___ b. If such a reconciliation would not be useful, have the principal differences between the two bases been described?

___ 21. If the presentation is a forecast, are the accounting principles used the same as those expected to be used in the historical statements covering the prospective period? (AICPA Guide 400.13)

___ 22. If the presentation includes a projection (see item No. 4) and the accounting principles used are not the same as those expected to be used in the historical statements covering the prospective period: (AICPA Guide 400.13P)

___ a. Is the use of the different principles disclosed? (Differences between two principles may also be reconciled and disclosed.)

___ b. Is the use of different principles consistent with the purpose of the presentation?

___ 23. If the prospective statement gives the effect of a change in accounting principles from a principle used in prior-period historical financial statements, is the change properly reported as would be required in historical statements? (AICPA Guide 400.16)

___ 24. If a forecast is accompanied by an outside reviewer's report, are the reviewer's qualifications, the relationship of the reviewer to the issuing entity, and the extent of the review disclosed? (Optional)

Comments:

BL-009 REVISED (Original # 260-OE)
Farm Credit Bank and Association Appointed Directors

December 15, 2006

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Farm Credit Bank and Association Appointed Directors

Congress recognized that, in a cooperative, a board of directors needs the authority to appoint a limited number of directors. In 1987, Congress added to the Farm Credit Act of 1971, as amended (Act), the authority for Farm Credit banks and associations to appoint directors, including at least one director who has no affiliation with the Farm Credit System (outside director). Congress explained that directors appointed under this authority are intended to provide an independent perspective and some additional expertise in appropriate areas.[1] In January 2006, FCA issued a final rulemaking addressing the governance of Farm Credit banks and associations. In this rulemaking, the eligibility, term of office, number and selection of outside directors was addressed in § 611.220 of FCA regulations and the definition of "outside director" was provided in FCA regulation § 619.9235.[2] The rule is silent, however, on the eligibility, term of office, number and selection of other appointed directors.

Background

FCA believes it is permissible under the Act for Farm Credit bank and association boards of directors to appoint stockholders to serve as directors (other appointed directors), except that associations may only appoint voting stockholders under sections 2.1 and 2.11 of the Act. The overarching objectives in selecting outside directors and other appointed directors is to enhance and strengthen the governance of the institution as well as to enhance the capacity of the board of directors to represent the interests and concerns of the institution's owner-borrowers. Consistent with these objectives, bank and association boards may appoint directors for specific public policy purposes, such as facilitating diversity or acquiring needed skills. In considering the selection of other appointed directors, each bank and association should balance the desire for optimum size boards against the identified need to add certain skills or improve diversity.

FCA believes that the authority to appoint directors, when used appropriately, does not impinge on corporate democracy or jeopardize the status of a Farm Credit bank or association as a cooperative. FCA emphasizes that stockholders in a cooperative have the right to vote for directors, and, therefore, use of director appointments is, by necessity, limited. Accordingly, FCA recently established a requirement that each Farm Credit bank and association board must consist of at least 60 percent stockholder-elected directors.[3] Bank and association boards should carefully consider the overriding cooperative principle of stockholder control and should not treat the regulatory 60 percent stockholder-elected director requirement as a maximum requirement.

Policy on Appointing Directors

FCA expects each Farm Credit bank and association board to develop and adopt a policy that formalizes compliance with the appointed director provisions of the Act by addressing the purpose for, and the search and selection processes of, appointing directors to the board. The policy should describe the appointment process and explain how the appointed director(s) add diversity or skills to the board, thereby strengthening the board's governance. To facilitate identifying the skills needed on the board of directors, each bank and association is required, under § 611.210(a), to establish a written policy identifying desirable director qualifications. This requirement is applicable to all director positions. As a result, banks and associations must make a reasonable effort to appoint outside directors and other appointed directors who have some or all of those desired qualifications.[4]

All directors have the same fiduciary responsibilities to each institution's stockholders, regardless of how they are selected. All directors must also have the same voting rights, and related responsibilities and duties, and be subject to the same rules and requirements, including requirements on pledges of confidentiality, disclosures, and conflicts of interest. Therefore, outside directors and other appointed directors have full voting rights on all matters that come before the board of directors. Accordingly, no director sitting on the board at the time of the vote should be denied the opportunity to vote on the appointment of additional directors.[5]

The policy should also address the removal procedures developed pursuant to § 611.220(b). Although § 611.220(b) requires Farm Credit banks and associations to establish and maintain procedures for the removal of outside directors, institutions may find the procedures appropriate for all appointed directors. The FCA believes that the term of office[6] and basis for removal should be the same for all directors serving on the institution's board. In addition, an outside director must be removed if the director becomes an officer, employee, stockholder, or agent of any Farm Credit institution or a director of another Farm Credit institution. FCA encourages institutions to amend their bylaws to address an appointed director's length of service and basis for removal.

Conflicts of Interest

Appointed directors must be willing and able to assume the responsibilities, exercise the authority, and comply with the same regulatory requirements, including standards of conduct and conflicts of interest, as stockholder-elected directors. Appointed directors are subject to FCA standards-of-conduct (Part 612) regulations and disclosure regulations (Part 620). Farm Credit institution boards must exercise diligence in the selection of appointed directors to avoid any conflicts of interest, whether actual or perceived, and to ensure that such individuals can function in a totally impartial manner. Selection of appointed directors who have ongoing business or borrowing relationships with the institution demands increased caution to ensure compliance with applicable regulations. Boards of directors that are engaged in merger discussions should avoid using their appointment authority to transition the boards just because they cannot agree on a governance plan for the continuing institution.

Institutions are reminded that § 611.310, which prohibits a person from serving as a director if that person was a salaried officer or employee of any Farm Credit bank or association at any time during the previous year, applies to all directors, including appointed directors. Banks and associations might use a similar cooling-off period prior to appointing any individual who unsuccessfully sought a stockholder-elected seat on the board in a recent election. Use of this type of a cooling-off period further preserves the cooperative principles on which the Farm Credit System is formed by honoring the voting stockholders' decision not to elect the individual as a director in that election cycle.

Use of the Term "Director"

We are aware that some institutions have used terms such as "Associate Director" or "Director Emeritus" even though the designated individual does not have the same rights, duties, and responsibilities as other directors. Use of an honorific containing the term "director" creates confusion for stockholders, employees, and the FCA as to the person's responsibilities and whether the person is subject to FCA rules on director qualifications, training, conflicts of interest, disclosures, and reporting. Therefore, we discourage institutions from using the term "director" for anyone not having a director's full responsibilities.

If a Farm Credit bank or association board desires to include positions that are not full directorships, the board should use an alternate title, such as "advisor to the board." If an institution decides to retain "director" in titles for positions that are not full directorships, then the institution should make it clear to all stockholders, employees, and the FCA what the limitations of the position are, as well as ensure the confidentiality of proprietary information that may be shared with individuals occupying such positions.

For further information on director conduct and responsibilities, please refer to the handbook titled The Director's Role available on FCA's website at www.fca.gov. Any comments or questions on this communication should be addressed to Andrew D. Jacob, Director, or Gary Van Meter, Deputy Director, in the Office of Regulatory Policy at (703) 883-4414, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov.

[1] Congress "believed it would be prudent for all boards to have a disinterested, objective member . . . ." 133 *Cong. Rec.* S. 16831 (December 1, 1987).

[2] 12 C.F.R. 619.9235 defines "outside director" as "[a] member of a board of directors selected or appointed by the board, who is not a director, officer, employee, agent, or stockholder of any Farm Credit System institution."

[3] 12 C.F.R. 611.220(a)(2).

[4] 12 C.F.R. 611.220(a)(1).

[5] The only exception is that an appointed director cannot vote in his or her own selection and removal.

[6] Certain events, such as mergers, consolidations, or mid-term board vacancies, may cause a temporary difference in the terms of office for all directors; however, these events would apply to all directors whether elected or appointed.

Copy to: The Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

BL-010 (Original # 271-OE)
Farmers Home Administration (FmHA) Guaranteed Loans -- Capitalization of Interest

October 16, 1990

To: The Chief Executive Officer
All Farm Credit Institutions

From: David C. Baer, Director
Office of Examination

Subject: Farmers Home Administration (FmHA) Guaranteed Loans—Capitalization of Interest

During the course of certain Farm Credit institution (FCI) examinations, Farm Credit Administration examiners have found that provisions in notes on FmHA-guaranteed loans permit the compounding of interest. We requested the FmHA to review those provisions and inform us of any impact on the validity of the guarantee.

The FmHA has responded that all guaranteed loans governed by Lender Agreements revised May 16, 1983, and later, are void if the promissory note provides for the payment of interest on interest.

The two examples that FmHA reviewed and indicated would void the guarantee are shown below:

1. COMPOUNDING AT MATURITY-DEFAULT INTEREST. If all or any part of this total amount due under this Note or any installment thereof is not paid at maturity, whether maturity occurs by reason of acceleration or otherwise, then at the Association's option, all remaining accrued interest shall be added to the past due principal balance. After maturity, the outstanding principal balance, including compounded interest, if any, shall bear interest at the default rate.

2. ADDITIONAL AGREEMENTS AND OBLIGATIONS OF PARTIES. The borrowers, endorsers, sureties, guarantors, and all other persons who may become liable for all or any part of the indebtedness evidenced hereby severally agree to the following:

   "That if this Note is placed in the hands of an attorney for collection or to protect or enforce any of the Association's rights hereunder, their liability to the Association shall extend to and include, to the extent permitted by applicable federal or state law, reasonable attorney's fees not to be less than 20% of the sum of unpaid principal, compounded interest, and accrued interest together with all court costs and all other fees, costs and expenses paid or incurred by the Association in connection with the collection of this loan."

If your institution's note form contains the above or similar provisions which permit capitalizing interest at default on FmHA-guaranteed loans, then the note must be corrected to ensure the FmHA guarantee is valid.

The FmHA has suggested that affected FCIs contact the respective FmHA state director concerning making any necessary amendments to promissory notes.

FCA examines will continue to review and classify FmHA-guaranteed loans based upon a determination of the validity of the guarantee.

BL-011 (Original # 279-OE)
Farm Credit Investment Bonds

December 20, 1990

To: The Chief Executive Officer
Each Farm Credit Bank
Federal Farm Credit Banks Funding Corporation

From: David C. Baer, Director
Office of Examination

Subject: Farm Credit Investment Bonds

Attached is a copy of a letter from the Department of the Treasury to Chairman Steele granting exemption from the provisions of sections 15C(a), (b), and (d) of the Securities and Exchange Act of 1934 as amended by the Government Securities Act of 1986 (Pub. L. 99-571, 100 Stat. 3208, 15 U.S.C. 780-5(a), (b), and (d)) to all associations of the Farm Credit System with respect to the sale of Farm Credit Investment Bonds. The letter describes in some detail the requirements with which any investment bond program must comply to maintain the exemption granted.

Those banks and associations that sell investment bonds should evaluate their programs to assure strict compliance with these requirements. FCA examiners will be reviewing and investment bond program in future examinations. In these examinations, particular attention will be given to the adequacy of disclosure of the characteristics of the instrument being sold and the financial condition of the selling institution and to compliance with the procedural restrictions on association involvement in the program.

Attachment

DEPARTMENT OF THE TREASURY
BUREAU OF THE PUBLIC DEBT
WASHINGTON, D.C. 20239-0001

November 26, 1990

Dear Mr. Steele:

We have received letters from the Farm Credit Bank of St. Paul and the Production Credit Association of Minnesota Valley (June 12, 1990), and the Western Farm Credit Bank and several associations in the Western District (June 21, 1990) requesting exemptions from the provisions of Sections 15C(a), (b), and (d) of the Securities Exchange Act of 1934 (Exchange Act), as added by the Government Securities Act of 1986 (GSA) (Pub. L. 99-571, 100 Stat. 3208, 15 U.S.C. 78o-5(a), (b), and (d)). The requests for exemptions stem from activities conducted in connection with the sale of Farm Credit Investment Bonds. The two requests are similar to a request for exemption from registration previously submitted by the Farm Credit Bank of Baltimore and Keystone Farm Credit ACA (Keystone), dated October 4, 1989. An exemption was granted in response to that request.[1]

In consideration of the requests precipitating this response, we examined the Investment Bond program for the entire Farm Credit System. We understand the salient facts to be as follows.

A. Structure of the Farm Credit System Institutions

The Farm Credit Banks (FCBs) are federally-chartered instrumentalities of the United States, created by the mandatory mergers of Federal Land Banks and Federal Intermediate Credit Banks, as provided for in Section 410 of the Agricultural Credit Act of 1987 (1987 Act) (Pub. L. 100-233 (uncodified); 12 U.S.C. 2011 note). The FCBs, as part of the Farm Credit System, are subject to regulation and examination by the Farm Credit Administration (FCA) (12 U.S.C. 2002 and 2254). The FCBs and other institutions comprising the Farm Credit System are intended to serve the credit needs of farmers and ranchers, while encouraging participation in the management, control, and ownership of the system (See 12 U.S.C. 2001).

One of the primary functions of the FCBs is to provide funding for the lending operations of the various associations within each of their territories. These associations, created or continued pursuant to the 1987 Act, are: Federal Land Bank Associations, Federal Land Credit Associations, Production Credit Associations, and Agricultural Credit Associations.[2] Like FCBs, these associations are regulated and examined by the FCA. They are, by statutory designation, or as the result of statutorily-mandated mergers, federally-chartered instrumentalities of the United States.

Eligible borrowers of the different associations include farmers, ranchers, producers, harvesters of aquatic products, and other eligible persons as described in the Farm Credit Act of 1971, as amended by the 1987 Act, and regulations of the FCA (12 U.S.C. 2017 and 12 CFR 613 Subpart B).

In order to obtain a loan from any of the associations, a borrower must become a member by purchasing stock or participation certificates in an amount required by the association's by-laws. Thus, each association, a federally-chartered instrumentality of the United States, is owned by its member-borrowers. The board of directors of each association consists of stockholders elected by its voting membership, and one board member, selected by other members of the board, who is not a stockholder, officer, employee, or director of any Farm Credit System institution.[3]

B. The Investment Bond Program

The transactions that are the subject of the requests for exemptions involve instruments referred to as Farm Credit Investment Bonds (IBs). IBs are issued by, and are obligations of, individual FCBs, and are issued pursuant to 12 U.S.C. 2153(b), (e), and the regulations of the FCA (12 CFR 615.5110-5130). IBs are government securities pursuant to Section 3(a) (42) (B) of the Exchange Act (15 U.S.C. 78c(a) (42) (B)), having been designated by the Secretary of the Treasury for exemption pursuant to Section 3(a) (12) of the Exchange Act (15 U.S.C. 78c(a) (12), 43 FR 24933). The FCA consults with Treasury regarding the issuance of IBs (12 CFR 615.5000(e)).

The IBs to be issued by the various FCBs are subject to a number of limitations imposed by statute and the FCA. These limitations include, among other things, that issuance of the bonds be subject to approval by the FCA and that the eligible purchasers be limited to employees, retired employees, and members of FCBs and associations within the issuing FCB's territory. IBs are issued, subject to instructions of the FCA regarding their terms, at varying maturities, interest rates, minimum investments, penalties for early redemptions, and reinvestment terms. While IBs can be issued in definitive form, it has been represented that they are currently issued only in book-entry form.

C. Involvement of the Associations in the Investment Bond Program

Some FCBs have proposed that interested associations in their respective districts provide certain services related to the sale of IBs. It is the nature of these services which has raised questions concerning a need to register and ultimately to the requests for exemptions. It has been represented that the involvement of associations with respect to the sale of the IBs would be limited to certain specified activities that have been represented as clerical and/or ministerial in nature, and limited to the following.

The associations would stock and make available printed informational materials provided by the FCB issuing the IBs and would not provide any information other than that set forth in the printed materials. The printed materials will clearly state that the FCBs and not the associations are the issuers of the IBs.

Any association member or employee that wanted to purchase an IB could contact their association's office or the respective FCB. The association or FCB would obtain the necessary information to issue the IB. If obtained at the association, it has been represented that the information is transmitted to the FCB, and the appropriate book-entry record creating the security is recorded based upon the information.

It has been represented that funds to purchase IBs are made directly payable to the FCB and, in some instances, may be directly transmitted. Upon redemption of the IBs, the proceeds are issued directly from FCBs to investors. The associations do not maintain custody of customer funds.

It has been represented that FCBs compensate associations for their costs associated with the sale of IBs. Different methods of calculating reimbursement for actual expenditures have been described to Treasury. In all cases, the level of reimbursement is left to the discretion of the FCB and the amounts may or may not equal the costs of distribution. The FCB can unilaterally adjust the amounts of reimbursement. It has been represented that while reimbursement may be based on a percentage of the principal amount or a percentage of the savings realized from obtaining lower cost funds through the sale of IBs, there are no commissions or any transaction-based compensation paid to employees in connection with the sales of IBs, and that in no circumstance, are fees charged to investors by the associations.

Furthermore, it has been represented that the activities of the FCBs and associations with regard to IBs, including the content and distribution of the printed informational materials, are reviewed by the FCA as part of its regular examination procedures. We also understand that associations with direct lending authority are examined on an annual basis while those with indirect lending authority are examined on-site every three years (off-site examinations are conducted during the intervening years (See 12 U.S.C. 2254)).

It has been represented that the activities conducted by the associations are ministerial and clerical in nature not amounting to those of a broker. However, to the extent that an association's activities could be considered to be those of a broker, it has been requested that the association be exempted from the registration requirements set out at Section 15C of the Exchange Act in light of the limited nature of the IB program and existing federal oversight.

D. Request for Exemption and Treasury's Response

We have discussed in our previous letter to Keystone and the Farm Credit Bank of Baltimore the roles of the FCBs and various associations, as part of the Farm Credit System, in providing the United States agricultural sector with a dependable source of credit. Since interest in receiving exemptions extends beyond one FCB district, we have decided to evaluate the requests for exemptions submitted by the Farm Credit Bank of St. Paul and the Western Farm Credit Bank in the context of the entire Farm Credit System. Given these considerations, and the representations that have been made in the letters requesting exemptions, we have determined that exemptions from the registration requirements of Section 15C of the Exchange Act and the regulations thereunder are warranted and should apply to all associations within the Farm Credit System. These exemptions are granted without consideration of whether the activities conducted by the FCBs and associations are those of a government securities broker or dealer.

In order to ensure that investors are sufficiently protected, however, the exemptions are subject to the limitations described below. We have determined that these exemptions are consistent with the public interest, the protection of investors, and the purposes of the GSA given the current structure of the Farm Credit System, the unique nature of the IBs, and the limited activities of the associations and their employees. We have consulted with the staff of the Securities and Exchange Commission as well as the FCA in reaching this decision.

Accordingly, pursuant to 15 U.S.C. 78o-5(a) (4), we hereby grant exemptions from the provisions of Sections 15C(a), (b), and (d) of the Exchange Act (15 U.S.C. 78o-5(a), (b), and (d)), and the regulations thereunder, to the various associations that comprise the Farm Credit System with request to the aforementioned securities transactions subject to the following limitations: (i) that the activities of the associations with respect to the IBs be limited to the stocking and distributing of the informational materials furnished by the FCBs and the taking and transmitting of investor information needed to effect sales; (ii) that any responses by employees to investor questions will be limited to relating information contained in the informational materials, and no employee will discuss the merits of, or recommend the purchase of, IBs or any other security; (iii) that the printed materials clearly state that the FCB and not the association is the issuer of IBs, that IBs are not direct obligations of the United States, and that IBs are in no way insured or guaranteed as to principal or interest by the United States or any governmental entity; (iv) that all sales of IBs arranged by the associations take place on the premises of the associations; (v) that the associations may not maintain custody of customer funds in connection with purchases and redemptions of IBs (i.e., funds for purchases of IBs must be directly payable to the FCB and all proceeds (redemption and interest) are made directly from the FCB to investors);[4] (vi) that association employees may not receive any compensation related to transactions in IBs; (vii) that associations may not charge a fee to investors; and (viii) that the IB program, including the content of informational materials, will be subject to regular examination by the FCA.

These exemptions pertain only to the sale of IBs within a single FCB district (i.e., an association in one district may not distribute IBs issued by an FCB of another district). Any change in the facts or circumstances of your request would require further analysis and could lead to termination of the exemptions.

Pursuant to 17 CFR 400.2(c) (7) (i), the incoming letters and this response will be made immediately available to the public.

Sincerely,

Richard L. Gregg
Commissioner

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[1] Letter from Richard L. Gregg to Glen L. Stevens and Bernard C. Flory (March 5, 1990) granting request for exemption from registration.

[2] See amendments to 12 CFR 613-616, and 619 set out at 55 FR 24861 (June 19, 1990) which reconcile

the authorities of institutions created by mergers required or authorized by the 1987 Act.

[3] 12 U.S.C. 2072 (Production Credit Associations), 2092 (Federal Land Bank Associations). As merged associations, Federal Land Credit Associations and Agricultural Credit Associations derive similar structures from their comprising entities.

[4] In a previous exemption granted to Keystone and all other Agricultural Credit Associations within the Farm Credit Bank of Baltimore District (March 5, 1990), it was represented that redemptions were handled through a zero balance account maintained by Keystone at a depository institution. Treasury has informed Keystone and the Farm Credit Bank of Baltimore that if the associations wish to remain exempt from the registration and regulatory requirements, all proceeds must be issued directly from the Farm Credit Bank of Baltimore to the customer. The associations have been given 60 days from the date of this letter to comply with this requirement.

Harold B. Steele, Chairman
Farm Credit Administration
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cc: David C. Baer, FCA
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John J. Spano, President
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Pacific Coast Federal Land Bank Association

Fred W. Hoffmeyer, President
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Federal Land Bank Association of El Centro

J. Allen Akkerman, President
Visalia Production Credit Association and
Federal Land Bank Association of Visalia

BL-012 (Original # 281-OE)
Asset/Liability Management Practices

January 15, 1991

To: Chairman, Board of Directors
The Chief Executive Officer
All Farm Credit Institutions

From: David C. Baer, Director
Office of Examination

Subject: Asset/Liability Management Practices

PURPOSE OF BOOKLETTER

The Farm Credit Administration (FCA) has studied the asset and liability management (ALM) practices and interest rate risk (IRR) exposures of Farm Credit institutions (FCIs) and has developed the following guidelines to inform boards of directors of the agency's views concerning this area. The FCA will be increasing its examination of ALM-related areas and may require institutions having inappropriate ALM practices or excessive IRR to reduce risk levels or increase capital.

REGULATORY REQUIREMENT

The FCA is charged with the responsibility of ensuring that FCIs are operating in a safe and sound manner. Appropriate ALM practices and excessive IRR are therefore of primary concern to the FCA. FCA Regulation 12 CFR 615.5200(b)(7) requires boards of directors of FCIs to establish capital adequacy plans that take into consideration the impact of interest rate risks on their institutions.

FCA ALM EXAMINATIONS

FCA guidelines for the ALM and IRR areas apply to institutions having direct lending authorities. The scope of the FCA's examination of ALM practices and IRR exposures will depend on the agency's determination of the risks embodied in each institution's operations.

One of the areas reviewed in determining the scope of ALM examinations will be the IRR exposures of associations versus district banks resulting from the manner in which direct loans are structured. The extent to which loan pricing practices support financial goals will also influence the scope of ALM examination efforts.

Lending program options, such as an institution's use of contractual limitations on interest rates or prepayment penalties on loans, will be considered when setting examination scope. Another ALM concern that will be examined is the practice of pricing loans to borrowers based on an index that may not directly relate to the underlying cost of financing the loans.

GENERAL DISCUSSION

The ALM process is the act of planning, acquiring, and directing the flow of funds through an organization. The ultimate objective of this process is to generate adequate/stable earnings and to steadily build an organization's equity over time, while taking reasonable and measured business risks. One obstacle to the achievement of this goal is interest rate risk, which is defined as the susceptibility of an institution's net interest income (NII) and market value of equity (MVE) to changes in interest rates.

ALM relationships embody the entire scope of a financial institution's operations (types of loans, loan rate structures, sources of funding, profit expectations, etc.). Because of this, an effective ALM program includes an integrated process of coordination, analysis, and communication that must include all operational units.

The FCA believes that boards of directors should institute the necessary policies and make sure that the appropriate procedures are in place and followed to ensure that their institutions have appropriate ALM practices and are not exposed to excessive levels of IRR. Board members should also understand the significance of IRR exposure, periodically review the exposure to ensure that it is commensurate with the institution's operations and that it is limited to prudent levels. Management is responsible for structuring the institution's balance-sheet and off-balance-sheet transactions in a manner consistent with the board's directives.

Listed below are several areas the FCA believes are important in an ALM program. These areas will be examined in institutions whose NII and MVE are exposed to changes in interest rates.

The issues discussed throughout this document should be considered normal expectations of the FCA in relation to institutions having IRR exposure. These expectations do not, of course, preclude institutions from engaging in additional techniques of measuring and managing asset/liability relationships.

1. ASSET LIABILITY MANAGEMENT POLICY

An important component of an acceptable ALM function is the development of an appropriate ALM policy. Policies provide boundaries for decision making and represent the philosophies and attitudes of an institution's board of directors.

Directors should assure themselves through their policies that decisions are not being made without measuring and considering the exposure of earnings and capital to potential interest rate movements. The ALM policy should contain at least the following areas:

1. Purpose statement;

2. A description of the ALM decision making process (this will normally include the

composition, operation, and responsibilities of an Asset Liability Management Committee (ALCO));

3. The establishment of acceptable levels of interest rate risk (expressed in terms of the impact changing interest rates will have on an institution's net interest income and market value of equity) and how risks will be measured;

4. Authorizations and parameters on the use of off-balance-sheet transactions;

5. Delegations of authority and formalized accountability;

6. Permissible exceptions and related procedures; and

7. Monitoring procedures, internal controls, and reporting requirements.

A critical element of the board of directors' ALM policy is the establishment of explicit limits on the institution's exposure to IRRs. Because the ability to control IRR requires a clear understanding of risk exposures, a board policy in which the IRR limit is expressed only in terms of repricing gaps will not normally be considered sufficient.

In institutions having IRR exposures, policy limits should specify, at a minimum, the maximum percentage change the board of directors is prepared to accept over the next 12 months in the institution's projected NII and MVE. These changes should be computed as a result of a parallel plus and minus 200-basis-point instantaneous and sustained shift in interest rates from the yield curve in existence at the time of the projection. This simulated rate change will allow boards to see how the financial condition of the institution would be affected from one reporting period to another.

2. A/L MANAGEMENT PROCESS

An appropriate ALM process should begin with the development of an institution's plans and goals. Plans should define the major direction in which the institution wants to proceed, its character and mission, and how it proposes to position itself to achieve a profitable and competitive posture. Because of their critical role, an institution's ALM and strategic planning processes should be properly and effectively integrated.

Many problems can be averted by establishing a proactive financial planning process that stresses ALM. This process leads boards and management to define expectations. Corporate financial goals should be established at least in the areas of profitability, growth, operating expenses, interest rate risk, and capitalization. These goals represent the agreed-upon financial targets that have been set in pursuit of strategic objectives.

Another component of an appropriate ALM process involves the development of a formalized, disciplined management approach to the entire area. This process allows management and boards of directors to identify and understand the risks already embedded in their institutions' balance sheets. Boards and management need to be aware of the consequences of inaction compared with the costs and/or benefits of potential strategies and actions that might change the institutions' risk profile.

The ALM process requires management and board members to review the impact of simulated changes in future interest rates on their institutions' income and capital. Scenarios reviewed should include a best case, worst case, and most likely projection, and should be done at least quarterly. Where appropriate, simulations should also be used to analyze how interest rate swaps, financial futures, options, debt buybacks, and other planned ALM actions could be used to reduce the possible negative effect of future changes in interest rates.

FCIs should have an asset/liability management function. It is expected that in most institutions this function would be administered by an asset/liability management committee (ALCO) comprised of senior officers. An ALCO would be responsible for monitoring, coordinating, and directing the acquisition, allocation, and pricing of the institution's resources in such a way as to maximize profits, manage interest rate risks, and adhere to predetermined financial standards and goals established in the financial plan. The ALCO should review interest rate (income and expense) and operational projections, competitive pressures, economic conditions, and regulatory activities in arriving at necessary decisions. The committee's regulatory activities in arriving at necessary decisions. The committee's work should be ongoing and dynamic, the natural consequence of which is the development of operating instructions and guidelines for specific units of the institution. The ALCO should be responsible for developing appropriate strategies and have the authority to implement its decisions.

3. APPROPRIATE MANAGEMENT INFORMATION SYSTEM

Management and boards of directors need to maintain or have access to an effective management information system to ensure that their ALM responsibilities are being met. This system should be comprehensive enough to allow management to evaluate current IRR exposures, track an institution's performance, assist in developing meaningful planning initiatives, and run appropriate simulations.

An effective ALM process is predicated on a management information system that provides decision-makers with timely, accurate information. In an attempt to provide these types of information processing capabilities, all Farm Credit Banks have purchased computerized sensitivity/simulation models. These models should allow management to experiment with different strategies, interest rate assumptions, yield curves, pricing approaches, projected changes in volume, various prepayment levels, and a host of other variables. Management information systems of this nature give management the ability to develop a better understanding of how the complexities of future events may affect their earnings and capital positions.

4. APPROPRIATE LOAN PRICING PRACTICES

The establishment of appropriate loan pricing practices is critical to the development of an acceptable ALM function. Loan pricing programs need to be established to ensure that loans are being priced in such a manner as to cover the costs associated with the loans and provide the capitalization needed to protect the institution against losses and allow for growth.

FCA Regulation 12 CFR 614.4270 requires institutions to charge interest rates on loans to borrowers that take into account the cost of money, necessary reserves and expenses, capital requirements, and services provided to the institutions' borrowers and members.

A letter concerning pricing practices was sent from the FCA to all FCIs on October 28, 1986, which stated that the establishment of rates that result in a return insufficient to cover expenses will be considered an unsafe and unsound practice and may require the FCA to initiate corrective action.

FCIs are encouraged to strengthen their loan pricing programs to ensure that new loans are priced according to their creditworthiness and inherent IRRs. FCIs are also encouraged to utilize transfer pricing programs where funding costs are assigned to individual loans and earnings credits are monitored on the profitability of the transaction. Lending programs of this nature can help increase accountability and assure that an institution meets its planning objectives.

5. CONTROL AND REPORTING MECHANISMS

Institutions need to have the appropriate controls and reporting mechanisms in place to ensure that operations are being conducted in a safe and sound manner. Controls include requiring staff to fully document the objectives of actions taken to mange IRR before implementation and requiring postanalysis to see if objectives are being met. Additional controls might include a separation of the risk measurement and reporting function from the risk management process and the development of appropriate internal audit programs.

Detailed reports should be prepared at least quarterly that tell directors what interest rate risks currently exist in the institution, what could happen to the institution under different interest rate projections, and what can be done at the time the analysis is completed to mange future risks. As previously stated, best case, worst case, and most likely interest rate scenarios should be reviewed and the effects of 200-basis-point shifts in interest rates on existing balance sheets should be analyzed.

Major assumptions, such as the lag time between increases in costs of funds and increases in lending rates, should be carefully documented and justified by historic analysis or based on board-approved future operating plans. The impact of changes in major assumptions should also be highlighted in subsequent reports presented to boards.

SUMMARY

The FCA wants to be sure that directors and management of FCIs understand that they are responsible for establishing, monitoring, analyzing, understanding, and managing the ALM practices of their institutions. They are responsible for ensuring that their institutions are not exposed to excessive levels of IRR. These guidelines are intended to notify FCIs in advance how the FCA intends to exercise its discretionary authority in ensuring that ALM practices are being managed in a safe and sound manner.

Please direct any inquiries regarding the contents of this document to Gregory L. Yowell at (703) 883-4371.

BL-014 (Original # 321-OE)
Government Seizure of Property Used in Connection with Controlled Substances

March 19, 1992

To: The Chief Executive Officer
All Farm Credit Institutions

From: David C. Baer, Director
Office of Examination

Subject: Government Seizure of Property Used in Connection with Controlled Substances

Under various authorities, law enforcement agencies may seize, and cause to be forfeited, real property and improvements which are obtained with the proceeds of activities or which are used in any manner to facilitate violations committed in connection with controlled substance offenses. Conveyances which are used or intended for use in any manner to facilitate the transportation of controlled substances are also subject to seizure and forfeiture. These activities are permitted by several Federal, State, or local laws and are governed principally by the Drug Abuse Prevention and Control Act, the Controlled Substances Act, and the Comprehensive Crime Control Act. Although enforcement is often connected with conveyances, authority exists to seize liened real property or chattels held by lenders, including Farm Credit System institutions.

Specifically, 21 U.S.C. 881 provides forfeiture authority for particular subject property. Paragraph (a)(7) provides that the following is subject to forfeiture to the United States: "All real property, including any right, title, and interest (including any leasehold interest) in the whole of any lot or tract of land and any appurtenances or improvements, which is used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, a violation of this title punishable by more than one year's imprisonment, except that no property shall be forfeited under this paragraph, to the extent of an interest of an owner, by reason of any act or omission established by that owner to have been committed or omitted without the knowledge or consent of that owner." In relation to possible chattels, the statutes provide that all conveyances, including aircraft, vehicles, or vessels, which are used, or are intended for use, to transport, or in any manner to facilitate the transportation, sale, receipt, possession, or concealment of controlled substances, are subject to seizure and forfeiture.

The "innocent owner" concept, included in the quoted portion of section 881, provides an avenue of relief from forfeiture to a lienholder. The lienholder institution seeking to judicially protect its innocent owner status must establish that the act giving rise to the seizure was committed without the lending institution's knowledge or consent nor at any time did it have any reason to believe that the property was being or would be used in a violation of the law. Altogether, the guidelines for exercising the innocent owner defense are rather stringent.

Any Farm Credit System institution encountering situations where collateral may be involved with possible illegal controlled substance offenses should contact the U.S. Attorney's office where the property is located. An important course of action for judicially protecting a lender's innocent owner status is prompt and cooperative communication with law enforcement agencies. Each institution is encouraged to begin a dialogue with its local U.S. Attorney's Office to establish procedures that can be used to protect the institution's innocent owner status.

All seizures of property should also be promptly reported to the appropriate FCA examination field office.

Please contact Robert Coleman at (703) 883-4231 if you have any questions.

BL-018 (Original # 391-OE)
Disclosure of Farm Credit Administration Reports of Regular Examination to Small Business Administration with Application for Approved Lender Status

June 21, 1994

To: Chairman, Board of Directors
The Chief Executive Officer
Each Farm Credit Bank
Each Production Credit Association
Each Agricultural Credit Association
Each Federal Land Bank Association
Each Federal Land Credit Association

From: Billy Ross Brown, Chairman
Farm Credit Administration Board

Subject: Disclosure of Farm Credit Administration Reports of Regular Examination to Small Business Administration with Application for Approved Lender Status

The purpose of this bookletter is to inform you of a recent action taken concerning disclosure of Farm Credit Administration (FCA) reports of regular examination (reports) to the Small Business Administration (SBA) in connection with application for approved lender status under the SBA's guaranteed loan program.

FCA reports are the property of the FCA and may be disclosed only with the consent of the Chairman of the FCA Board. The FCA has in the past approved the release of reports to the SBA for Farm Credit System institutions (FCSIs) on a case-by-case basis when needed as part of the application for approved lender status under the SBA's guaranteed loan program. In response to a number of recent requests from several FCSIs for permission to release reports to the SBA, the FCA Chairman has granted conditional consent to release regular examination reports to the SBA solely for use in qualifying FCSIs as approved lenders.[1] The FCA and the SBA have enter into a written agreement concerning the limited use of these reports (copy attached). Each FCSI that provides a report to the SBA must maintain documentation to substantiate that the SBA returned the report to the FCSI following completion of the application for approved lender status.

The consent for disclosure is conditioned on compliance with these conditions. Release of reports to SBA without complying with the conditions imposed by this bookletter and the agreement is a violation of 12 CFR 602.205.

If you have any questions, please call Jerry Erickson, Policy Development and Planning Division, at (703) 883-4231.

Attachment

[1] This consent applies only to FCA reports of regular examination and does not apply to reports of special examination. Any consent to disclose reports of special examination will be handled on a case-by-case basis.

AGREEMENT BETWEEN FARM CREDIT ADMINISTRATION BOARD AND SMALL BUSINESS ADMINISTRATION

Whereas, pursuant to 5 U.S.C. § 552(b), 12 U.S.C. §§ 2243, 2252, and 2254, and 12 C.F.R. § 602.205 and 602.289, Reports of Examination of Farm Credit System institutions made by the farm Credit Administration (FCA) are exempt from disclosure by the FCA; and

Whereas, in order for the Small Business Administration (SBA) to confer approved lender status on certain Farm Credit System institutions (institutions), it is necessary to make reports of regular examinations of the institutions (Reports) available to the SBA.

Now therefore, in the interest of assuring the confidentiality of the Reports, it is agreed that the Reports will be made available to the SBA on the following terms and conditions:

1. The SBA shall use the Reports of the examination of a particular institution and the information contained therein only for the purpose of designating that institution as an approved lender under the SBA's guaranteed loan program. The SBA agrees not to photocopy or quote directly from such Reports.

2. The SBA shall maintain the Reports as confidential documents of the FCA to the extent permitted by law and shall not disclose the Reports, which remain FCA property, or the information contained therein without the prior written approval of the FCA. If the SBA receives a request for the disclosure of the Reports or any of the information contained therein, the SBA shall promptly notify the FCA of the request so that the FCA can assert any exemptions, privileges, or objections.

3. Once the SBA has finished using the Reports of the examination of a particular institution for the purpose set forth in #1 above, the SBA agrees to return the Reports directly to that institution.

Dated this 8th day of June, 1994.

FARM CREDIT ADMINISTRATION BOARD

By: ________________________________
Billy Ross Brown, Chairman

SMALL BUSINESS ADMINISTRATION

By: ________________________________
John R. Cox
Associate Administrator for Financial Assistance

BL-020 (Original # 404-OE)
Leasing Authority of Farm Credit Banks and Agricultural Credit Banks Operating Under Title I, and Direct Lender Associations

December 22, 1994

To: Chairman, Board of Directors
The Chief Executive Officer
Each Farm Credit Bank
Each Agricultural Credit Bank
Each Production Credit Association
Each Agricultural Credit Association
Each Federal Land Bank Association
Each Federal Land Credit Association

From: Marsha Martin, Chairman
Farm Credit Administration Board

Subject: Leasing Authority of Farm Credit Banks and Agricultural Credit Banks Operating Under Title I, and Direct Lender Associations

In recent months, the Farm Credit Administration (FCA) has addressed several issues concerning leasing programs administered by Farm Credit institutions. The purpose of this bookletter is to provide clarification of the statutory leasing authorities of Farm Credit Banks (FCBs), and Agricultural Credit Banks (ACBs) operating under Title I, and direct lender associations operating under Title II.

Farm Credit banks and associations derive their leasing authorities from the lending provisions of the Farm Credit Act of 1971, as amended (Act).

From time to time, there has been some confusion over whether leasing falls under a Farm Credit System (System) institution's lending authority or its authority to provide financially related services. This situation is partly due to the location of FCA regulation § 618.8050 under part 618. At this time, the FCA is clarifying that the System's leasing powers are derived from the lending provisions of the Act.

Sections 1.11(c)(2) and 2.4(b)(4) of the Act grant Farm Credit banks and associations, respectively, express leasing powers. The structure of the Act and its legislative history reveal that leasing is a separately enumerated power that supplements the lending authorities of FCBs, ACBs, and associations, not a financially related service pursuant to sections 1.12 and 2.5 of the Act. Leasing provides eligible borrowers with other options for financing the acquisition of facilities and equipment through either financing or operating leases.

The lending and leasing authorities are subject to the same requirements concerning: (1) the scope of financing; and (2) activities conducted outside an institution's chartered territory pursuant to 12 CFR 614.4070. Furthermore, FCBs, ACBs, and associations may enter into lease transactions only with eligible borrowers who are bona fide farmers, ranchers, or aquatic producers or harvesters because of the statutory and regulatory requirement that the equipment or facilities leased must be needed in the lessee's operations.

Leasing authorities of Federal Land Credit Associations (FLCAs) are not the same as those of Production Credit Associations (PCAs).

When FCBs were created, they inherited separate and distinct leasing authorities from their constituent Federal Intermediate Credit Banks and the Federal Land Banks. As a result, FCBs and ACBs are authorized to make: (1) equipment leases pursuant to their short- and intermediate-term lending authorities; and (2) facility leases pursuant to their long-term real estate lending authorities. Under section 7.6 of the Act, an FLCA assumes its transferor bank's authority to make and participate in only long-term real estate loans; therefore, it is only authorized to make long-term facility leases. The Federal Land Bank Associations have no express leasing authority.

The PCAs, under section 2.4(b)(4), are authorized to make only short- and intermediate-term equipment leases. The PCAs and FLCAs may operate joint equipment leasing programs as long as the PCA is the lessor or holds title to the leased assets in its name, and records all lease transactions on its balance sheet. The ACAs have authority to make both long-term facility and short- and intermediate-term equipment leases.

Stock purchase is required by statute for some, but not all, leases.

Section 1.11(c)(2) authorizes FCBs to lease facilities and equipment to "persons eligible to borrow"; whereas, section 2.4(c)(4) of the Act authorizes PCAs to lease equipment to "stockholders." Based on these authorities, the FCA has determined that stock purchase is not required for facility leases. With regard to equipment leases, stock purchase is required for those leases made by a PCA or ACA, but not those made by an FCB or ACB.

The minimum stock purchase requirement contained in section 4.3A(c)(1)(E) applies only to "loans." For this reason, each PCA or ACA may determine the class and amount of stock that it will require for equipment leases. A PCA or ACA may require equipment lessees to purchase only a single share of stock provided that the association continues to meet its minimum permanent capital level under section 4.3 of the Act. Such stock requirements must be included in the institution's capitalization bylaws.

The lending limit applies only to financing leases.

Under FCA regulations in subpart J of part 614, financing leases must be included in the lending limit calculations of each System institution. Similarly, financing leases are treated as loans for the purpose of calculating Farm Credit System Insurance Corporation insurance premiums. Operating leases, which are ordinarily reported as fixed assets on an institution's balance sheet, should not be included in lending limit or insurance premium calculations.

Further basis for distinguishing between the two leases rests with their tax treatment. Rental payments under an operating lease are fully tax deductible to the lessee.[1] A financing lease qualifies as a conditional sale under the Internal Revenue Code. Under such a lease, the lessee is permitted to deduct interest payments and depreciation on the equipment.

Those institutions that have addressed leasing in their financially related services and technical assistance policies should make the appropriate changes. In making such changes, FCBs will not be required to resubmit their policies to the FCA for prior approval.

If you have any questions, please call Charlotte Miller, Policy Development and Planning Division, at (703) 883-4483.

Copy to: CoBank-National Bank for Cooperatives
Springfield Bank for Cooperatives
St. Paul Bank for Cooperatives

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[1] For tax purposes, an operating lease complies with the following requirements: (1) the lessor must expect to derive a profit from the transaction; (2) the lessee may not lend funds to the lessor to acquire the leased property, or guarantee the lessor's debt; (3) the lease should expire before the end of the economic life of the leased property so that the lessor's investment in the equipment remains at risk; (4) lease payments must amortize only the value of the equipment consumed during the lease term; (5) at the end of the lease, the lessee may not have the right to purchase the equipment for less than its fair market value; and (6) the lessee is not allowed to furnish any of the cost of the leased property, and the lessor cannot accept down payments or trade-ins.

BL-023 (Original # 425-OE)
Guidelines for Utilizing Derivative Products

October 31, 1995

To: The Chief Executive Officer
All Farm Credit Banks
Federal Farm Credit Banks Funding Corporation

From: David C. Baer, Director
Office of Examination

Subject: Guidelines for Utilizing Derivative Products

This Bookletter[1] sets forth the Farm Credit Administration's (FCA) views on the use and management of derivatives by Farm Credit institutions (FCIs). It also provides detailed guidance for FCIs to use as they establish or review systems for controlling risk. While this guidance is oriented for use by Farm Credit banks, any FCI engaged in the use of derivative products is expected to manage them in a safe and sound manner and will be subject to evaluation by examiners based on the attached criteria. If managerial or operational systems are found to be insufficient, the FCI may be required to modify its systems, increase capital, or take other protective actions.

Derivative products are financial contracts that derive their value from the performance of other instruments, indexes, or relationships. Examples include interest rate swaps, futures, options, forward rate agreements, and structured financings. When managed properly, derivative products can be efficient, powerful financial tools that enhance stability of business operations. They also can allow money managers the opportunity to structure an institution's balance sheet to help achieve desired objectives in almost any economic environment. Within the Farm Credit System, derivatives have been used to reduce borrowing costs, improve liquidity, manage basis and prepayment risks, improve investment returns, and achieve specific asset/liability management objectives.

The significant increase in the types of complex derivatives, the various conditions that affect their value, and the continually evolving derivative market present considerable risk to derivative users. Failing to understand, identify, and manage such risk can have a sudden and significant impact on an institution's financial position. Using derivatives for speculative purposes, such as placing leveraged bets on the future direction of financial markets or the purchase of structured notes[2] without regard to § 615.5132, Investment Purposes, increases their risk. The FCA considers any speculative use of derivatives an unsafe and unsound banking practice.

The use of financial derivative products requires special expertise, experience, and rigorous controls. The FCA expects critical management systems to be in place and should be employed commensurate with each institution's use of derivative products.

FCIs using derivatives, or planning to do so in the future, should use the attached guidance in establishing or reviewing their derivative operations. Controls and management systems should be updated as new technologies are developed or changes in an FCI's activities cause current systems to become obsolete.

Please direct your questions on the subject of this document to Gregory Yowell, Senior Financial Analyst, Accounting and Examination Policy at (703) 883-4371 or contact the FCA field office assigned to examine your institution.

Attachment

Copy to: Chief Executive Officer
All Farm Credit Associations
All Farm Credit System Service Organizations

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[1] This Bookletter replaces FCA's August 27, 1990, Bookletter 265-OE, entitled "Guidelines for Interest Rate Swaps."

[2] As used, the term structured notes refers to investments with complex derivative-based features. These instruments include, for example, step-ups, index-amortizing or dual-indexed notes, and leveraged or range bonds. Structured notes are normally considered inappropriate for liquidity reserve purposes. Further, structured notes should not be used for any investment purpose unless management can demonstrate the MIS capabilities, controls, and expertise needed to evaluate and hold the security.

GUIDELINES FOR USE OF DERIVATIVE PRODUCTS BY FARM CREDIT SYSTEM INSTITUTIONS

The following guidelines and expectations will be used by examiners in evaluating a Farm Credit institution's (FCI) use, planned use, and management of derivative products. This document should be used by FCIs in establishing or reviewing their derivative operations. The guidelines are a complement to and should be read in conjunction with:

1. FCA Investment Regulations (as they apply to derivative products);
2. FCA Regulation 12 CFR 615.5135, "Management of Interest Rate Risk";
3. FCA January 15, 1991 Bookletter 281-OE, "Asset/Liability Management Practices"; and
4. FCA *Examination Manual* : Financial Module, Asset/Liability Management (ALM); Asset Module, Investments; and, Management Module, Internal Controls.

BOARD OF DIRECTOR RESPONSIBILITIES

The board of directors' role related to derivatives is to ensure the FCI's derivative activities are appropriate to its operations and risks are limited to prudent levels. Derivative programs need to begin with active involvement of the board of directors in establishing policies that delineate appropriate program controls and limits. The board needs to formally approve, as part of its ALM policy, a section addressing the use of derivative products, allowable risk parameters and tolerances, and controls/management systems for derivative activities. This section of the policy should be reviewed and updated as needed, but in any event, at least annually, by the board to ensure the following are addressed properly:

1. The scope of the FCI's planned involvement in derivatives and the authorized purposes for using derivatives.

2. A clear delineation of the responsibilities for managing the derivatives program and associated risks.

3. Expectations for risk management systems and measurement techniques. Expectations for both should be consistent with the nature, size, and complexity of the derivative portfolio.

4. Limits for portfolio makeup, instrument maturities, credit risk, and the level of earnings and capital at risk.

5. Controls and monitoring and reporting requirements needed to achieve compliance with approved policies.

At the time of the annual policy review, boards and management should discuss thoroughly the risks associated with the allowed derivatives and how each derivative product will be used. Utilization of derivative products where the type or purpose is not addressed in the policy should not occur at significant levels until comprehensive evaluation provides the board, senior management, risk management, legal, and accounting personnel full understanding of the associated risks and benefits.

Board members should discuss an FCI's derivative activities on a regular basis with senior management and other appropriate personnel. To facilitate discussion, each board should receive quarterly reports from the FCI's Asset/Liability Management Committee (ALCO) describing the institution's current derivative activities. Data reported to the board should be presented in an easily understandable and summary manner. The information should include discussions of derivative portfolio performance and variances from established guidelines. Submissions should also provide explanations and plans for resolving identified variances or concerns.

SENIOR MANAGEMENT RESPONSIBILITIES

Senior management must ensure appropriate procedures, management systems and expertise are in place for conducting derivative operations in accordance with board policy. Through procedures and management systems, senior managers must ensure that all significant risks arising from derivative transactions are quantified, monitored, and controlled.

Management also should ensure existence of a documented process for evaluating derivatives. This process should include sufficient detail to allow a third party to determine if the objectives, advantages, and risks of derivatives were identified before approvals were given and positions booked. The process also should document the performance of significant derivative positions taken and provide for routine reporting of results to an FCI's ALCO and its board of directors.

Staffing—One of management's most important responsibilities is to ensure FCI staff possess the expertise necessary to understand and identify the risks and benefits associated with derivatives. FCIs may rely on external experts for a portion of these skills, but must have sufficient internal skills to provide effective controls and oversight. Finally, compensation programs for staff dealing with derivatives should not be structured to encourage speculative activities.

Internal Controls—Controls are a joint responsibility of the board and senior management and should be sufficient to ensure compliance with relevant laws, regulations, policies, and procedures. Key controls must provide for the preventive detection of **unauthorized** transactions to ensure that only **authorized** transactions take place. Controls also must ensure that risk management and measurement systems are operating effectively and that management information systems are providing reliable and timely reporting and analysis. The appropriateness of each aspect of an FCI's management controls will be considered by examiners in the context of the materiality of the risk posed to the FCI by its use or planned use of derivatives.

As a further control, appropriate separation of duties within an FCI's derivative operations must exist. In particular, those individuals responsible for measuring, monitoring, and controlling risk should be independent of individuals who execute derivative transactions. Responsibilities for processing and verification of payment requests, cash management, margin calls, and collateral requirements should be assigned to individuals independent of those responsible for executing derivative transactions.

FCIs using derivative products should have this activity audited at least annually by qualified internal auditors. Also, the board should consider using external evaluation services to ensure derivatives are being appropriately managed.

Management Information System (MIS)—Management must ensure that FCIs have sophisticated MISs that (1) capture necessary data, (2) process transactions, (3) identify and track existing risks, (4) project risks under differing economic scenarios, and (5) monitor performance and compliance with existing policy and procedural constraints. On a transactional basis, the MISs should be sufficient to (1) allow staff to monitor hedge ratios, (2) calculate and verify margin requirements, (3) monitor the effectiveness of transactions, (4) compute net credit exposures and market valuations, (5) determine if existing positions need to be adjusted or terminated, (6) handle settlements, (7) track collateral, and (8) calculate the final results of actions taken.

MANAGEMENT OF RISKS ASSOCIATED WITH DERIVATIVE INSTRUMENTS

The types of risks associated with other financial activities also apply to the use of derivative products. Each of the risk areas discussed below should be addressed by FCIs using derivatives.

Interest Rate Risk (IRR)

Interest rate risk management is one of the principal purposes for which FCIs use derivative products. Prior to using derivatives, FCIs need to (1) define the level and types of IRRs that exist in their balance sheet, (2) analyze and understand what causes these risks, (3) measure the impact these risks may have on projected earnings and market values under a variety of possible scenarios, and (4) establish objectives for proposed actions to manage risks. FCIs must then monitor actions taken to ensure the purposes for which they were intended continue to be met.

Credit Risk

Credit risk is the prospect of failure by a counterparty to perform on an obligation to another institution. Credit risks are a particular concern for derivatives not traded on established exchanges. Credit limits for all derivative counterparties, which take into account the aggregate of all credit exposures to a particular counterparty, should be established by personnel who have credit expertise and are independent of money desk operations. The FCI's MIS should provide management with information concerning credit exposures in relation to current limits. FCIs are encouraged to utilize master agreements with netting provisions and bicollateralized swap agreements, as appropriate, to reduce credit risk. Finally, assets pledged as collateral in a derivative transaction cannot be counted as part of the FCI's liquidity reserve, nor may they be used to collateralize the issuance of Systemwide debt.

Legal Risk

Legal risk is the risk that contracts are not legally enforceable. This risk can be significant in over-the-counter derivative contracts. FCIs are responsible for ensuring that (1) contracts with counterparties are legally enforceable, (2) the terms of the agreement are legally sound and properly documented, (3) counterparties have the legal authority to engage in the transaction being considered, and (4) the FCI entering the transaction understands the terms of derivative commitments. It is strongly encouraged that any master agreements related to derivatives undergo legal review prior to execution.

Liquidity Risk

Liquidity risk, as it relates to derivatives, is the risk that an institution will be unable to execute a transaction at a reasonable price. Liquidity risk typically arises when credit risk exposure to a counterparty requires an FCI to liquidate or offset a particular derivative position. When reacting to control the liquidity risk, FCIs then become subject to associated market risks impacting the value of the affected derivative or the cost of the derivative needed for an offset position. The degree of market risk is aggravated when an inadequate primary or secondary market exists for the derivative subject to liquidation or offset. FCIs using derivatives should be aware of the size and depth of the markets corresponding to its derivative portfolio and establish appropriate limits and controls to address liquidity risk. Further, the inclusion of early termination or collateral clauses in derivative contracts should be reviewed for impact on liquidity.

Operational Risk

Operational risk arises when an institution fails to take appropriate action due to deficiencies in its management systems, internal controls, or understanding of the terms of a derivative product. It is imperative that FCIs have the operational expertise, internal controls, processing capabilities, financial resources, and management information systems necessary to successfully conduct derivative programs. It is essential that operational units accurately capture all relevant details of transactions, identify errors, and provide management with sufficient information to monitor risk exposures in a timely manner. FCIs also should have emergency contingency plans in case primary systems become inoperable.

Derivative transactions are normally consummated by the telephone. FCIs should consider the advantages of making audio recordings of these transactions to the extent permitted by law. FCIs always should ensure that supporting written confirmations are obtained. Trade tickets also should be completed at the time derivative transactions occur. Tickets should document the date and time of the trade, whether it was a buy or sell, the type of instrument being utilized (including its terms and conditions), the quantity bought or sold, the transaction price, the broker or counterparty, and a description of the trade's purpose.

BL-027 (Original # 438-OE)
Loan Participation Requirements

March 27, 1996

To: The Chief Executive Officer
All Farm Credit Institutions

From: William L. Robertson, Acting Director
Office of Examination

Subject: Loan Participation Requirements

Several Farm Credit System (FCS or System) institutions have raised questions about the scope of their authorities to participate in loans and leases under various provisions of the Farm Credit Act of 1971, as amended (Act).[1] In response, this Bookletter provides FCS institutions with specific guidance about: (1) the application of the independent credit requirements in § 614.4325(e) to the purchase of participation interests and other interests in pools or portfolios (hereafter referred to as pools) of loans;[2] (2) the authority of FCS banks and associations to participate with non-FCS lenders in loans to similar entities under sections 3.1(11)(B) and 4.18A of the Act; and (3) lease participation authorities of FCS lending institutions and service organizations that are chartered under section 4.25 of the Act.

I. How does the "independent credit judgment" requirement in § 614.4325(e) apply when an institution purchases an interest in a pool of loans from other FCS institutions or non-FCS financial institutions?

The independent credit judgment requirement of § 614.4325(e) applies equally to an interest in a single loan or a pool of loans.[3] The FCA recognizes that loan participation interests can effectively diversify loan concentration risk within an institution's portfolio.[4] However, loan participation interests expose System institutions to other types of risks. Although these risks can be managed, FCS institutions must be aware of such risks, and take them into consideration when they decide whether to purchase a participation or other interest in such loans.

The following passage from the preamble of the proposed regulation explains the FCA's reasons for requiring FCS institutions to conduct an independent credit analysis and reach an independent credit judgment when they purchase participation or other interests in loans:

> [T]he purchase of participation interests or other interests in loans without adequate independent analysis to make an independent objective decision by the purchasing

> institution on the borrower's creditworthiness and the quality of the asset is an unsafe and unsound practice. . . . The FCA believes that these requirements are necessary to the effective discharge of the [purchasing institution] board's fiduciary responsibility to the institution's stockholders to ensure that adequate internal controls are in place to safeguard its assets.[5]

The ultimate responsibility for the solvency of each System institution rests with its board of directors. For this reason, § 614.4325(e) requires the board of each FCS bank and association to independently: (1) analyze the institution's exposure to various risks associated with the purchase of a participation interest or other interest in either an individual loan, or a pool of loans; and (2) decide whether or not the purchase of the interest in question furthers the business goals and risk management objectives of the institution. Under § 614.4325(e), the board's accountability for such decisions cannot be delegated to a lead lender, agent, or other intermediary because such decisions directly impact the individual institution's solvency and viability.[6]

A. Does § 614.4325(e) require System banks and associations to exercise an independent credit judgment on every individual loan in a pool of loans?

No. Section 614.4325(e) requires an institution to exercise its independent credit judgment on any transaction to purchase a participation interest or other interest in an individual loan or pool of loans. However, § 614.4325(e) provides an FCS institution with the flexibility to conduct a due-diligence analysis on a sample of loans in a pool in which the institution will purchase a participation interest or other interest. Such a due-diligence analysis should be based on safe and sound underwriting criteria consisting of a composite evaluation of credits through the use of appropriate techniques. The FCS institution must be able to justify its assumptions when it relies on such composite evaluation techniques. The analysis also should include an evaluation of the originator, lead lender, servicing agent, or other intermediary's management capabilities, underwriting policies, and servicing procedures. In addition, when an interest in a pool of loans is originated to conform with, or is purchased under, a common set of underwriting criteria, such as a credit scoring system, the analysis may involve a review of the underwriting criteria, together with a reasonable sampling of the loans sufficient to ensure the consistent application of the criteria.

B. Are there situations when a due diligence analysis of a sample of loans in a pool of loans will not satisfy the requirements of § 614.4325(e)? If so, when is a heightened level of review and analysis required for a pool of loans?

Although System institutions are authorized to perform a due-diligence analysis on a sample of loans in a pool, every institution is also expected to conduct a separate, in-depth analysis of any loan(s) in the pool that could significantly increase the institution's exposure to a material risk of loss. As a result, each System lender is expected to assess its own vulnerabilities to loss, and decide when a pool of loans, or any portion thereof, merits a higher level of scrutiny commensurate with the institution's risk-bearing and management ability.

As an example, each System bank and association purchasing a participation interest or other interest in a pool of loans would be expected to conduct a separate analysis of individual loans that have characteristics concerning size, terms, conditions, or the nature of the borrower's enterprise that are significantly different from the majority of loans in the pool. To the extent that such individual loans pose greater risks of loss, prudence requires that the purchasing institution conduct an analysis of these individual loans separately from its due-diligence analysis on a composite sample of the rest of the loans in the pool.

Similarly, an institution's risk of loss also may increase if it acquires an interest in a pool of loans that is substantially dissimilar and requires different expertise than management of its own portfolio of loans. In such situations, an FCS institution may not be familiar with the risks inherent in certain types of credit, therefore, the institution should apply a greater degree of review and analysis to the purchase of such participations making sure that the associated risks are properly identified and addressed.

In addition, a higher level of review and analysis would be required if the purchase price of the interest of any of the individual loans within the pool equals a material portion of the System institution's capital. In contrast, a due-diligence analysis of a composite sample of loans in a pool would normally satisfy the requirements of § 614.4325(e) if the FCS institution purchases an interest in a pool of small loans that, in the aggregate, equals a material portion of the institution's capital.

C. Does § 614.4325(e) prohibit an FCS lender from delegating any decisions about the credit to a lead lender, agent, or intermediary?

No. The FCA has previously acknowledged that certain functions and decisions pertaining to credit administration may be delegated to a lead lender, agent, or other intermediary. The following passage in the preamble to the final regulation explains the FCA's position on the delegation of authority to outside parties:

> The final regulation grants the participants some discretion to delegate, by contract, certain judgments or servicing actions to either the lead lender or an agent. The final regulation does not require all participants in a loan to review decisions on nonsubstantive matters. The FCA considers certain servicing actions, such as granting time extensions for certain reporting requirements, releasing non-material portions of collateral, or granting a reasonable forbearance for meeting defined financial covenants, as nonsubstantive in nature. . . . Nevertheless, the FCA continues to believe that each participant must

independently review and agree to any action which substantively alters either the terms of the loan or the participant's interest therein.[7]

As noted earlier, the subject of agent relationships and delegated authorities, by the institution to such agents, is addressed in more detail in the proposed Loan Underwriting regulations, which were adopted by the FCA Board at the March 12, 1996 Board meeting.

II. How do the "similar entity" authorities in sections 3.1(11)(B) and 4.18A of the Act expand the authority of System banks and associations to participate in loans with non-FCS lenders?

The Farm Credit Banks Safety and Soundness Act of 1992[8] and the Farm Credit System Agricultural Export and Risk Management Act[9] granted System banks and associations new authorities to participate in loans originated by non-System lenders. These new statutory authorities have expanded the loan participation authorities of System lenders in two ways. First, the definition of "participation" differs for loans to (1) eligible borrowers and (2) similar entities. Section 614.4325(a)(4) defines "participation" in a loan to an eligible borrower as "a fractional undivided interest in the principal amount of a loan. . . ." However, sections 3.1(11)(B)(iv) and 4.18A(a)(1) ("similar entity" authorities) of the Act define "participation" in a loan to a similar entity more broadly as "multilender transactions, including syndications, assignments, loan participations, subparticipations, or other forms of the purchase, sale, or transfer of interests in loans, other extensions of credit, or other technical and financial assistance," which may consist of a fractional divided interest in the loan. Second, the "similar entity" authorities authorize FCS banks and associations to participate in loans to borrowers who would not be eligible to borrow directly, provided that the ineligible borrower has operations that are functionally similar to the operations of eligible borrowers.

In addition, the "similar entity" authorities of the Act impose three restrictions on participation interests by FCS banks and associations in loans to similar entities: (1) the total amount of credit that a System institution has outstanding to a single credit risk shall not exceed 10 percent (or such higher limit as authorized by FCA and approved by the institution's shareholders) of its total capital; (2) the "similar entity" authorities sections of the Act require that the participation interest(s) of one or more FCS institutions in the same loan cannot equal or exceed 50 percent of the principal amount of the loan at any time; and (3) the Act limits the amount of participation interests in similar-entity loans that each FCS bank or direct lender association may hold at any time to 15 percent of its total outstanding assets.

On September 11, 1995, the FCA proposed § 613.3300 to implement the similar entity provisions of the Act. *See* 60 FR 47103 (Sept. 11, 1995). As proposed, § 613.3300 would not permit an FCS lender that operates under title I of the Act to participate with a non-System lender in a loan that a title II institution could make directly to the borrower, and vice versa. The comment letters about proposed § 613.3300 indicate that some FCS institutions disagree with the FCA's interpretation of the Act, while other System institutions support it. The FCA is carefully considering the comments of all parties.

A. Is the "similar entity" status of a loan participation interest determined by the eligibility of the borrower or the lending authorities of the FCS institution? For example, could a Farm Credit Bank (FCB), or a Federal Land Credit Association (FLCA) participate with a commercial bank in a short- or intermediate-term loan to a borrower who is eligible to borrow directly from a production credit association (PCA)?

"Similar entity" status is determined by the characteristics of the borrower, not the lending authorities of the lender. Section 4.18A(a)(2) of the Act defines a "similar entity" as a person who (1) is not eligible for a loan from either a Farm Credit bank that operates under title I of the Act or a direct lender association; and (2) has operations that are functionally similar to a person who is eligible to borrow directly from such bank or association in that the entity derives most of its income from, or has most of its assets invested in, activities that are permissible for eligible borrowers. In other words, a similar entity is an ineligible borrower who requires financing for a purpose which a System lender is authorized to finance.[10]

If the entity is eligible to borrow from either a Farm Credit bank that operates under title I of the Act or a direct lender association, it is not a similar entity for any other title I or II lender, and the purchase of participation interests in loans to such borrowers is governed by sections 1.5(12)(C) and 2.4(a) of the Act, respectively, rather than section 4.18A. In addition, specific participation authorities for the various types of FCS institutions are addressed in part 614, subpart A of the FCA's regulations. Accordingly, participation in a loan to an eligible borrower must consist of a fractional undivided interest, and the loan terms must be compatible with the institution's lending authority.

As an example, an FCB or FLCA could not purchase from a non-System lender a participation interest in a short- or intermediate-term loan that a PCA could make directly to an eligible borrower.[11] Similarly, a PCA could not directly purchase a participation interest in a long-term mortgage loan from a non-System lender.[12]

B. Do the "similar entity" authorities of the Act enable FCS banks and associations to purchase from non-System lenders interests in loans, other than fractional undivided interests, to eligible borrowers?

No. Section 4.18A does not expand the authority of an FCS lending institution to participate with non-System lenders in loans that such System bank or association could make directly to the borrower. As a general rule, System banks and associations lack authority to purchase from a non-System lender whole loans and interests (other than fractional undivided interests) in loans to eligible borrowers.[13]

III. Can a service organization chartered under section 4.25 of the Act, such as

the Farm Credit Leasing Services Corporation (FCLC), sell lease participation interests to FCS banks and direct lender associations and, conversely, can such FCS banks and associations purchase lease participation interests from such service organizations?

Yes. As an FCS service organization chartered under section 4.25 of the Act, the FCLC has the same authorities, subject to limitations in its charter and articles of incorporation, as its parent institutions,[14] except that it cannot extend credit or sell insurance.[15] Therefore, despite the absence of any specific direction in subpart A of part 614 of the regulations pertaining to the FCLC's ability to purchase or sell participation or other interests in leases, section 4.25 of the Act authorizes the FCLC to participate in or sell and purchase interests in leases to the same extent as its parents. However, the FCLC cannot purchase or sell participation interests or other interests in loans because the Act prohibits such section 4.25 service organizations from extending credit to FCS borrowers.

In addition, System banks and direct lender associations are authorized by the Act and FCA regulation to sell to and purchase from other FCS institutions participation interests and other interests in loans and similar credits.[16] Therefore, FCS banks and associations are authorized to sell to and purchase from service organizations, such as the FCLC, participation interests and other interests in leases. The FCLC may also purchase from and sell to non-System institutions fractional undivided interests in leases to the extent of their parents' authority.

The FCA, with this Bookletter, has attempted to address some of the significant issues that have arisen pertaining to loan participation activities and participation authority issues related to the FCLC and other FCS institutions' leasing activities. However, there are other issues related to loan and lease participation activities that will require further analysis by the FCA. Such issues include: (1) lending limits and territorial concurrence for leases; (2) capitalization requirements; and (3) out-of-territory activities pertaining to leasing, loan participation, and the purchase and sale of loan interests. In addition, this Bookletter does not address whether service organizations that are chartered under section 4.25 of the Act are authorized to engage in similar entity transactions. These additional issues will be dealt with in future bookletters or regulatory revisions.

If you have any further questions on these matters, please contact Dennis Carpenter, Senior Policy Analyst, at (703) 883-4256.

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[1] For the purpose of this Bookletter only, the term "Farm Credit System institution" refers exclusively to System banks and associations.

[2] Proposed § 614.4325(a)(1) would revise the definition of "interests in loans" to expressly include transactions involving a pool of loans. *See* FCA Board Action on Loan Underwriting Proposed Rule (BM-12-MAR-96-03).

[3] *See* 57 FR 38237, 38241 (Aug. 24, 1992).

[4] According to § 614.4325(a)(4), "participation interest" refers to a fractional undivided interest in the principal amount of any loan that a lead lender sells to a participating lender.

[5] See 56 FR 2452 (Jan. 23, 1991). The FCA reaffirmed this position in the preamble to the final regulations. See 57 FR 38237 (Aug. 24, 1992).

[6] Proposed § 614.4325 provides clarification and additional direction pertaining to the delegation of specific transaction authorities to agents. (See FCA Board Action on Loan Underwriting Proposed Rule (BM-12-MAR-96-03).

[7] *See* 57 FR 38237 (Aug. 24, 1992).

[8] Pub. L. No. 102-552, § 502, 106 Stat. 4130 (Oct. 28, 1992).

[9] Pub. L. No. 103-376, § 2, 108 Stat. 3497 (Oct. 19, 1994).

[10] See 60 FR 47103, 47115 (Sept. 11, 1995). However, section 4.18A(b)(4) of the Act expressly precludes System banks that operate under title I of the Act and direct lender associations from participating in rural housing loans under their similar entity authorities.

[11] One method for FCS institutions to facilitate such "eligible borrower" participation with a non-System lender would involve a PCA or agricultural credit association (ACA) serving as an intermediary, purchasing the participation interest from the non-System lender and then selling a participation interest to the FCB or FLCA. Similarly, a FCB, FLCA, or ACA would have to purchase an interest in a long-term mortgage loan and then sell an interest to the PCA.

[12] Under sections 3.1(11)(B) and 4.18A of the Act, however, a party who is eligible to borrow from a title III lender may qualify as a similar entity for a System institution that operates under titles I or II of the Act, and vice versa. The definition of "participation" in sections 3.1 (11)(B)(iv) applies to such transactions because, for example, the eligible title III borrower is a similar entity for the title I or II lender that is participating in the loan. Furthermore, the Act imposes consent requirements when a title I or II lender participates with a non-System institution in a loan to a similar entity that is eligible to borrow directly from a title III bank, and vice versa.

[13] Farm Credit banks operating under title I of the Act and direct lender associations may only purchase certain qualified mortgage loans to eligible borrowers and interest therein from non-System lenders when they are pooling and securitizing loans for the Federal Agricultural Mortgage Corporation (Farmer Mac) pursuant to their respective authorities under sections 1.5 (24), 2.2(21) and 2.12(22) of the Act.

[14] Section 209 of the Farm Credit System Reform Act of 1996 (Pub. L. No. 104-105, 110 Stat. 162 (Feb. 10, 1996)) added a new section 4.28A, which revises the definition of "bank" in section 4.25 to include "each association operating under title II" of the Act.

[15] Section 4.25 of the Act states that a Farm Credit bank or group of banks can organize a service corporation for the purpose of performing functions and services for or on behalf of the organizing banks " . . . **Provided**, that a corporation so organized shall have no authority either to extend credit or provide insurance services for borrowers from Farm Credit System institutions, nor shall it have any greater authority with respect to functions and services than the organizing bank or banks possess under this Act. . . ."

[16] FCA regulations at § 614.4325(a)(3) define loans as any extension of credit or similar financial assistance of the type authorized under the Act, such as leases, guarantees, letters of credit, and other similar transactions.

BL-030 (Original # 445-OE)
Voluntary Advance Conditional Payment Accounts

April 17, 1996

To: Chairman, Board of Directors
The Chief Executive Officer
All Farm Credit System Institutions

From: Marsha Martin
Chief Executive Officer

Subject: Voluntary Advance Conditional Payment Accounts

The Farm Credit Administration (FCA) has noted an increasing use of voluntary advance conditional payment accounts (VACPs) by System institutions. Sections 1.5 (6) and 2.2(13) of the Farm Credit Act of 1971, as amended, authorize institutions to accept advance payments. FCA's regulations at 12 C.F.R. 614.4513(a) establish the general guidelines for VACPs. This bookletter conveys the safety and soundness considerations that will govern the FCA's examination of VACP policies and practices.

As the term VACP suggests, an institution may only hold these funds as an advance payment for a shareholder who has an outstanding loan or commitment from that institution. The amount of the loan or commitment from the institution limits the amount that can be placed in a VACP. For long-term mortgage loans, the VACP balance may not exceed the outstanding balance on the related loan(s). With proper documentation, a short-term lender may accept funds up to the amount of the borrower's outstanding line of credit or loan commitment. Commitment amounts should be based on sound underwriting standards and either the historic or reasonably projected borrowing needs to the borrower during the current operating cycle. The VACP balance should be at or below the projected maximum outstanding loan balance for related loans using a revolving line of credit.

FCA regulations provide that an institution may provide funds to the borrower from a VACP in lieu of increasing the borrower's loan. Institutions must manage VACPs to avoid liquidity risk, however. Acceptable approaches include retaining discretion for the timing of the release of funds, requiring adequate advance notice from borrowers, or limiting the aggregate amount of VACPs to the amount of available unused funding under the general financing agreement or other approved funding source. The interest rate paid on VACPs should consider the potential cost of replacing withdrawn funds from another source and the contract rate on the related loan.

An institution that accepts VACPs should have policies adopted by its board that provide guidance to management for VACP administration and that require periodic reporting to the board in sufficient detail to monitor VACP practices. Administrative guidance should address interest rates paid and any effect on asset/liability management, the documentation requirements for the size of the VACPs that are related to loan commitments, any limitations on the size or frequency of withdrawals, and other internal controls. Policies should require written agreements with borrowers and adequate disclosures regarding:

1. The fact that funds in the VACP are uninsured and an explanation of the risk in the event of liquidation of the institution;
2. Limits on amounts that can be paid into VACPs;
3. Interest rates that will be paid, including the terms of variable interest rates; and
4. Withdrawal guidelines or restrictions.

Because VACP funds are to be applied to outstanding loan balances, these funds generally should be accounted for as contra-assets. However, if the borrower's access to VACP funds is not restricted, amounts should be recorded as liabilities. Also, if the VACP is based on a loan commitment, any amount in excess of the related loan balance should be recorded as a liability.

During examinations of System institutions holding VACPs, the FCA will evaluate the institutions' VACP policies, procedures, and practices. If instances of inappropriate practices are identified, corrective action could include requiring that VACP balances be returned to the affected borrowers.

Questions regarding this bookletter should be directed to me at (703) 883-4007 or Terry Stevens, Office of Examination, at (703) 883-4483.

BL-036 (Original # 463-OE)
Farm Credit Administration's Approval Requirements for the Global Debt Program

August 30, 1996

To: The Chief Executive Officer
All Farm Credit System Banks

From: Marsha Pyle Martin
Chairman and Chief Executive Officer

Subject: Farm Credit Administration's Approval Requirements for the Global Debt Program

The Farm Credit Administration (FCA) has approved the Federal Farm Credit Banks Funding Corporation's (Funding Corporation) request to authorize the Funding Corporation to issue, on behalf of Farm Credit System (FCS or System) banks, global debt denominated in either U.S. dollars or foreign currencies. FCA's approval of the System's Global Debt Program (GDP) establishes criteria under which FCA will consider each System bank's request to issue global debt. This bookletter transmits a copy of the GDP approval and clarifies FCA's expectations regarding the issuance of foreign currency denominated debt (FCDD).

- Prior to requesting FCA approval to issue FCDD, each System bank should review and, if necessary, amend policies and procedures to ensure currency and counterparty risks are appropriately managed, monitored, and reported. FCA will evaluate each System bank's policies and procedures for monitoring, managing, and reporting counteparty and currency risk as part of the ongoing examination process. Based in this evaluation, FCA may deny a bank's request to issue FCDD. In evaluating policies and procedures, FCA examiners will expect the following:

- Each bank should establish policies and procedures that address currency risk. Examiners will expect policies to establish the maximum amount and maturity of FCDD that can be outstanding in any one currency and should incorporate country risk ratings. FCA's approval of the GDP establishes minimum country risk ratings that must be observed in each bank's policies and procedures.

- FCA's approval of the GDP requires that simultaneous with the issuance of FCDD, System banks, or the Funding Corporation on the banks' behalf, must execute a cross-currency swap to U.S. dollars that matches the underlying FCDD. Although FCA does not require that the Funding Corporation execute the cross-currency swap on behalf of the bank, procedures and controls must establish coordination with the Funding Corporation to ensure that the swap terms are consistent with the terms of the FCDD. On a case-by-case basis, FCA may approve issuance of FCDD that is not fully matched with a cross-currency if the FCDD obligation is used to offset other identified currency risk on the requesting bank's balance sheet. A bank requesting such approval should have procedures in place that clearly demonstrate and isolate the currency risks that are being hedged with the FCDD.

- FCA examiners will expect policies and procedures to require that cross-currency swaps be only with bank board-approved counterparties. FCA's approval of the GDP includes minimum credit ratings for cross-currency swaps that should be consistent with or incorporated into each bank's policies and procedures.

- Board policies should establish maximum counterparty exposure limits. The exposure limits should be based on the consolidated counterparty exposure for all derivative products (e.g., interest rate swaps, basis swaps, options, cross-currency swaps, etc.) and investments. Banks may wish to differentiate the exposure limits based on the credit rating of the counterparties and/or by whether or not the counterparty is subject to a collateralization agreement.

- Each bank's policies and procedures must address monitoring and reporting of counterparty risk. FCA examiners will expect banks to monitor both the current exposure position and peak (or potential) exposures under clearly defined stress tests. Peak exposures should be measured on a consolidated counterparty basis for all derivative products (e.g., interest rate swaps, options, cross-currency swaps, etc.) and investments. Each bank's procedures should include trigger points based on the peak counterparty exposures that would either limit further transactions with the counterparty and/or provide for implementation of strategies to reduce the peak exposure. Although banks may establish dollar exposure limits, FCA suggests that limits be expressed as percentages of permanent capital, total net worth, or unallocated surplus.

- Each bank's policies and procedures should address the impact of bi-collateralization agreements on the bank's free collateral position. FCA examiners will expect each bank to be able to compute, monitor, and report the peak (or potential) amount of collateral that the bank must pledge to counterparties under clearly defined stress tests and the impact such peaks will have on the bank's free collateral position. Each bank's procedures should include trigger points based on peak pledged collateral positions that would either limit further transactions and/or provide for implementation of strategies to reduce the peak pledged collateral.

- Each bank's policies or procedures should address the frequency of monitoring reports. FCA examiners will expect the bank's procedures to require more frequent monitoring of counterparty exposures and collateral positions in times of greater volatility and/or when the bank is approaching its established limits.

- Each bank must adopt appropriate policies and procedures for the accounting and reporting of transactions involving the issuance of FCDD. The FCA expects such policies and procedures to conform with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 52, Foreign Currency Translation, and other authoritative literature governing the accounting and disclosure of transactions involving foreign currencies.

- Each bank's policies and procedures should be adequately supported. FCA examiners, for example, will expect the bank to be able to support the reasonableness of policies and/or procedure limits and guidelines.

Each System bank that anticipates issuing FCDD should review and, if necessary, amend its policies and procedures with the above expectations in mind. Prior to requesting FCA formal approval to issue FCDD, each bank is encouraged to consult with its local examination office to ensure that FCA examiners are fully informed and early communication occurs relative to program criteria as outlined in this bookletter.

If you have any questions or concerns with FCA's expectations or approval of the GDP, please contact either your local examination office, me, Jim Enzler or Andrew Jacob of FCA's Office of Examination at

(703) 883-4483.

Attachment

FARM CREDIT ADMINISTRATION APPROVAL OF GLOBAL DEBT PROGRAM

The Farm Credit Administration (FCA) approves the Federal Farm Credit Banks Funding Corporation's (Funding Corporation) request to authorize the Funding Corporation to issue, on behalf of the Farm Credit banks, debt securities (global debt) under a Global Debt Program (GDP). Any changes to this approval require FCA Board action. As requested by the Funding Corporation, the GDP is limited to $5 billion in outstanding issues. FCA approval is subject to the GDP meeting the following FCA debt issuance conditions:

I. FCA approval process for global debt issuances. FCA's approval process for global debt issuances will distinguish between U.S. dollar denominated debt and foreign currency denominated debt (FCDD) as follows:

A. FCA will consider specific approval requests for U.S. dollar denominated debt issuances on a monthly shelf basis identical to the current medium term note (MTN) program.

B. The FCA will consider specific approval requests for FCDD issuances on a monthly shelf basis solely to facilitate timely action on investor inquiries (reverse inquiries), where the deal includes common FCDD terms, matching cross-currency swap to U.S. dollars, and final maturity of the FCDD does not exceed 5 years. Common debt terms are fixed rate, simple floating rate, callable, simple step-up, or amortizing securities.

C. FCA will consider individual prior-approval requests for all other FCDD issuances including reverse inquiries where the deal involves unique debt terms or unique variations of common debt terms. Any issuance with a maturity greater than 5 years, regardless of any optional redemption features, shall require FCA Board approval. Unique debt terms include complex floaters, specialized indexed, or other exotic structures such as inverse floaters, range floaters, stock indexed, exchange rate indexed, or complex step-up securities. If the Funding Corporation is uncertain of whether an individual or shelf approval is appropriate, it should contact the FCA. The banks' requests for approval of an FCDD issuance must include a draft term sheet and swap dealer confirmation listing the specific terms and conditions of the transaction.

Consistent with the MTN approval process, FCA may, at any time, require individual prior-approval requests for specific banks or types of securities. The Funding Corporation should provide the FCA with as much advance notice as possible of issuances under negotiation, particularly of FCDD issuances.

II. Evaluation of risk management systems. FCA will evaluate each Farm Credit System (System) bank's process for monitoring, managing and reporting counterparty and currency risk as part of the ongoing examination process. Based on this evaluation, FCA may deny a bank's FCDD funding request.

III. Simultaneous swap of currency risk. Simultaneous with the issuance of any FCDD security, System banks, acting in concert with the Funding Corporation, must execute a cross-currency swap(s) to U.S. dollars that fully matches the underlying FCDD. On a case-by-case basis, banks may request FCA approval to not fully match the foreign debt with a cross-currency swap if the FCDD obligation is used to offset and match other currency risks on the requesting bank's balance sheet. The cross-currency swap counterparty must be prior approved by each System bank's board.

IV. **Cross-currency swap counterparty credit rating requirement.** Counterparties to cross-currency swaps are limited to those counterparties considered to have an "upper-medium" credit rating. FCA defines an "upper-medium" rating as meeting at least two of the following: Moody's rating of A1 or better; Standard and Poor's rating of A or better; International Bank Credit Analysis, Inc. rating of A or better; and Thompson rating of B or better. Further, FCA requires System banks to obtain collateralization agreements for cross-currency swap counterparties that are rated below a "high" credit rating by a nationally recognized rating service. FCA defines a "high" rating as meeting at least two of the following: Moody's rating of Aa2 or better; Standard and Poor's rating of AA- or better; International Bank Credit Analysis, Inc. rating of AA- or better; and Thompson rating of A/B or better. A collateralization provision requires the swap counterparty to post collateral with a safe keeping agent when the net mark-to-market of all swap transactions exceeds a certain dollar threshold. Each System bank should negotiate reasonable thresholds as a function of the credit quality of the counterparty.

V. **Country risk rating requirement.** Issuances of FCDD are limited to currencies of countries with at least a Moody's sovereign country rating of Aa2 or a Standard and Poor's country foreign currency debt rating of AA.

VI. **Funding Corporation reporting to FCA.** The Funding Corporation will provide FCA a weekly detailed report of all issues under the GDP. The report should be consolidated with the weekly report on the MTN program and should include all global debt, MTN debt, unscheduled bond sales, and any swaps executed in conjunction with the debt issues.

VII. **Annual report on Global Debt Program.** Annually, the Funding Corporation must provide an analysis of the results of the GDP. The analysis should include the financing (including spread relationships) and operational costs of the GDP.

Recommended for Approval by:

Financial Analysts: ____
James E. Enzler and Andrew D. Jacob

Acting Director, Office of Examination: ____
William L. Robertson

Recommendation is hereby approved:

____

Marsha Pyle Martin
Chairman and Chief Executive Officer
Farm Credit Administration

BL-037
Lending Policies and Loan Underwriting Standards Regulations

October 28, 1997

To: Chairman, Board of Directors
Chief Executive Officer
Each Farm Credit Institution

From: Marsha Pyle Martin
Chairman and Chief Executive Officer

Subject: Lending Policies and Loan Underwriting Standards Regulations

The Farm Credit Administration (FCA) Board recently granted final approval for regulations on Lending Policies and Loan Underwriting Standards that are included in 12 CFR 614.4150. This bookletter clarifies the approach and expectations that FCA will use to examine compliance by Farm Credit System institutions (institutions) with these regulations.

The newly promulgated regulations provide flexibility so institutions may tailor lending policies and loan underwriting standards in accordance with safe and sound business practices commensurate with the needs and capability of the institution and its members. Although these regulations eliminated the requirement that System lenders obtain a verifiable balance sheet and income statement from most borrowers at least annually, institution boards and management should remain cognizant of the responsibility to obtain current and reliable financial information on borrowers as needed to properly measure and manage risks within the loan portfolio, and determine the allowance for losses.

Institution boards should avoid practices resulting in conditions that existed prior to 1985 when many institutions were unable to accurately assess risk because they did not have and were unable to obtain current financial information from borrowers. The need for current financial information on borrowers becomes even more crucial to appropriately evaluate risk and the institution's safety and soundness as conditions change in the lending environment or as conditions change under which loans were originally made. Therefore, in accordance with sound business practices, institutions will be expected to incorporate into borrower loan agreements (or any other legally binding instrument executed with the borrower at the time of loan closing) the requirement that borrowers provide at any time during the duration of the loan current, reliable, and verifiable financial statements (balance sheets and income statements) as requested by the lender subsequent to loan closing. This requirement should also be incorporated into legal instruments for lending programs that do not require verifiable or signed financial statements from borrowers at the initiation of a new loan. The failure of an institution to make provisions to obtain such financial information from the borrower upon request of the lender, or the failure to obtain current, reliable, and verifiable financial information from borrowers when conditions worsen in individual loans, segments of the loan portfolio, or the loan portfolio in its entirety, could be considered by FCA examiners as an unsafe and unsound practice that would require corrective action by the institution's board of directors.

The regulations prescribe, in general, the contents expected in lending policy and loan underwriting standards. FCA examiners will review board policies and procedures to determine that loan underwriting standards are established and implemented for all lending programs that the institution plans to offer. The institution's lending standards should be incorporated into such policies or procedures and establish the minimum credit and financial information required from borrowers. In considering this requirement, each institution should determine the frequency needed for the collection and verification of credit and financial information, commensurate with the risk in the loan and the type of credit extended, that will enable the institution to be kept apprised of the borrowers' operating performance or risk inherent in the loan. Accordingly, each institution's loan underwriting standards should include measurable standards to determine that the applicant has the operational, financial, and management resources to repay the debt from cash flow, and provide guidance on requiring collateral and other security as may be needed to ensure full collection of the debt in accordance with the terms established in the promissory note or other loan agreements.

The board of each institution should clearly prescribe its delegations of approval authority on loans, including delegations of authority to approve exceptions to underwriting standards. There should also be a process established for reporting to the board those actions taken under the authority delegated. Each institution should have internal control systems capable of monitoring compliance with loan underwriting standards and reporting exceptions to the institution's board and/or management.

The institution's underwriting standards should result in loans with acceptable risks, both on an individual basis and collectively as an entire portfolio. The FCA examiners will consider an acceptable level of risk as being risk which is commensurate with the institution's capital protection and management's ability to control risk. In this respect, the board of each institution should ensure that its loan underwriting standards are appropriate for the risk-bearing capacity of the institution within tolerances established by the board. Concentrations (whether they be by industry, loan size, or any other specialization) should be adequately measured and managed to limit the excessive exposure of capital to risk inherent in such loan portfolio segments. The board should also ensure that internal controls identify lending practices that may cause excessive risk or practices that threaten the financial condition of the institution so that prompt corrective actions can be taken.

Lending practices and loan underwriting standards should be reviewed periodically by board and management to ensure they appropriately preserve and strengthen the soundness and stability of the institution's financial condition and performance and are compatible with the lending environment. Such reviews for example, should take into consideration: planned actions within the context of the institution's strategic business plan to enter new market segments; changes in the economic, business, and lending environments; changes in government policies; changes in the institution's financial condition and risk bearing capacity; changes in principal credit personnel; and other factors that might change in those operating conditions under which the loan underwriting standards were established.

While each of the issues as discussed in this letter provides direction that will be considered in measuring compliance with 12 CFR 614.4150, each institution's board has the ultimate responsibility and fiduciary duty to ensure the institution operates in a safe and sound manner. Additional guidance in this area can be obtained by reviewing the FCA publication entitled The Director's Role. Copies of that publication are available from the Office of Congressional and Public Affairs, FCA, 1501 Farm Credit Drive, McLean, Virginia 22102-5090.

If you have any further questions on these matters, please contact me or Roland E. Smith, Chief Examiner, at (703) 883-4160.

BL-038
Guidance Relating to Investment Activities

November 26, 1997

To: The Chief Executive Officer
All Farm Credit System Banks
Federal Farm Credit Banks Funding Corporation

From: Marsha Pyle Martin
Chairman and Chief Executive Officer

Subject: Guidance Relating to Investment Activities

The Farm Credit System (Farm Credit) banks requested that the Farm Credit Administration (FCA) provide interpretative guidance concerning provisions of the investment management regulations in subpart E of part 615 and authorize new investments pursuant to § 615.5140(a)(11). The FCA has also received requests to revise certain provisions of the regulations so that Farm Credit banks will have greater flexibility to adapt to the continuing evolution of the financial markets.

This bookletter provides additional guidance to Farm Credit banks on the scope of their authorities under existing regulations to invest in mortgage-backed securities that are backed by mortgages that convert from a fixed-rate to an adjustable-rate, bank notes, and general obligations of State and municipal governments. In addition, this guidance provides an interpretation on whether Farm Credit banks are authorized to acquire hedge instruments that raise or remove the cap on floating-rate collateralized mortgage obligations and clarifies the liquidity reserve requirements in § 615.5134.

Petitions for change, various developments in the securities markets, improvements in risk management technologies, and modifications in the other financial regulators' approaches to managing risks in securities activities have also contributed to the need to reassess FCA's investment regulations. Thus, as noted in the Unified Agenda of Federal Regulations, the FCA Board plans to consider a rulemaking to revise the investment regulations during the spring of 1998. The proposed rulemaking will address issues beyond those included in this guidance.

A. Fixed/Floating Adjustable-Rate Mortgage Securities

Farm Credit banks are currently authorized by § 615.5140(a)(2) to invest in securities that are backed by either fixed-rate mortgages or adjustable-rate mortgages (ARMs) that satisfy certain conditions. According to § 615.5140(a)(2)(ii), eligible securities may be backed by ARMs that have repricing mechanisms of 1 year or less tied to an index.[1] Additionally, fixed-rate mortgage-backed securities (MBSs) that comply with the three-pronged test in § 615.5140(a)(2)(iii) are eligible investments for Farm Credit banks.[2]

Farm Credit banks have inquired about their authority to invest in MBSs that are collateralized by ARMs that bear a fixed-rate of interest for 3 or 5 years, and then adjust annually pursuant to an index. These "fixed/floating ARMs" are commonly referred to as 3/1 and 5/1 ARMs. In recent years, fixed/floating ARMs have become an important segment of the MBSs market.

Fixed/floating ARMs are a hybrid of fixed-rate and adjustable-rate MBSs because they share common attributes with both types of securities. The FCA determines that § 615.5140(a)(2) authorizes Farm Credit banks to invest in MBSs that are collateralized by mortgages that bear a fixed-rate of interest for a specified number of years and then reprice annually. These MBSs must comply with the requirements of § 615.5140 (a)(2)(iii) at the time of purchase and each quarter thereafter until the date of first repricing. Once these instruments begin to reprice every 12 months or less, they are subject to § 615.5140(a)(2)(ii), which governs adjustable-rate MBSs. This approach enables Farm Credit banks to invest in fixed/floating ARMs in a prudent manner.

B. Applicability of Hedge Instruments to the Farm Test

FCA regulation § 615.5140(a)(2)(iv) exempts floating-rate collateralized mortgage obligations (CMOs) from the requirements in § 615.5140(a)(2)(iii)(A) and (B) if interest rates remain below the contractual interest rate cap. Thus, floating-rate CMOs that bear interest rates below their contractual cap rate are only required to comply with the price sensitivity test in § 615.5140(a)(2)(iii)(C). The Farm Credit banks request that hedge instruments that are specifically purchased to raise or remove the cap on floating-rate CMOs should be considered along with the underlying CMOs for the purpose of determining whether the exemption in § 615.5140(a)(2)(iv) applies.

Purchasing hedge instruments that raise or remove the cap on floating-rate CMO investments is compatible with the risk management objectives of § 615.5140(a)(2)(iii). Such hedge instruments effectively counteract the risk that rates will rise above the embedded cap, thereby decreasing the price sensitivity of the floating-rate CMO to changing interest rates.[3]

For this reason, the FCA will permit Farm Credit banks to use hedge instruments to effectively raise or remove interest rate caps on floating-rate CMOs under the following conditions:

1. These investment activities comply with the requirements in FCA's bookletter (BL-023, October 31, 1995) concerning "Guidelines for Utilizing Derivative Products."

2. Farm Credit banks demonstrate that a hedge relationship exists between the hedge instruments and the underlying floating-rate CMO(s). Objectives for the hedge should be documented before the hedge instrument is purchased, and afterwards, Farm Credit banks should routinely monitor the performance of the hedge to ensure that these objectives are being met. Farm Credit banks should also be able to demonstrate that the hedge instrument can easily be sold in the event that the

underlying CMO is liquidated.

3. Farm Credit banks maintain documentation that the hedge transaction makes sound economic and business sense and adhere to the investment objectives and risk limits of the bank and FCA regulations. Essentially, Farm Credit banks must demonstrate that the primary purpose of a hedge is to reduce the price sensitivity of the CMO to changes in interest rates, rather than to merely qualify the investment for exemption under § 615.5140(a)(2)(iv).

C. Investments in Bank Notes

The FCA has reviewed § 615.5140(a)(8), which permits investments in certain corporate debt obligations, and determines that Farm Credit banks may acquire bank notes under this provision. The FCA concludes that bank notes are compatible with the investment objectives in § 615.5132. Bank notes are senior unsecured debt obligations of commercial banks. Active markets exist for both short-term bank notes that mature within 1 year and medium-term bank notes that mature within 5 years.

Bank notes are not insured deposits under section 3(l) of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. 1813(l), and therefore, holders of bank notes are general creditors of the issuing bank. Bank notes are corporate debt obligations of commercial banks. For these reasons, the FCA determines that Farm Credit banks may purchase and hold bank notes pursuant to their authority under § 615.5140(a)(8) to invest in corporate debt obligations that:

1. Maintain a credit rating of at least "AA" or its equivalent.
2. Mature within 5 years or less from the date of purchase.
3. Qualify as marketable investments pursuant to § 615.5131(j).
4. Do not convert into equity securities.

In accordance with § 615.5140(a)(8), corporate debt obligations cannot exceed 15 percent of each Farm Credit bank's investment portfolio. Additionally, § 615.5140(b) prohibits Farm Credit banks from investing more than 20 percent of their total capital in eligible investments of a single obligor.

When Farm Credit banks acquire bank notes that mature within 1 year or less, they may rely on the short-term ratings assigned by any nationally recognized statistical rating organization (NRSRO). For the purpose of § 615.5140(a)(8), the FCA considers a short-term rating of "A-1" equivalent to a "AA" long-term rating.[4]

D. Full Faith and Credit Obligations of State and Local Governments

The following discussion provides Farm Credit banks with guidance relating to the scope of their authorities under §§ 615.5140(a)(10) and 615.5140(a)(11) to invest in revenue bonds that are issued by State and local governments.

For the purposes of § 615.5140(a)(10), full faith and credit obligations are issued by a State or local government (including duly constituted governmental authorities that provide education, water and sewer, hospital, and public transportation services within a specified territory) that possesses powers of general taxation. In this context, the

State or local government is obligated to repay its debt with proceeds from income, sales, or property taxes. Other sources of revenue, such as fee income for governmental services or payments from the Federal government, may provide a credit enhancement for general obligation bonds that are issued on the full faith and credit of a State or local government. Additionally, full faith and credit obligations of State and local governments are eligible investments for Farm Credit banks under § 615.5140 (a)(10) if they: (1) maintain at least a rating of "A" or its equivalent by a NRSRO; (2) mature within 10 years from the date of purchase; and (3) qualify as marketable investments under § 615.5131(j).

Revenue bonds are debt obligations of local governments that are repaid from sources of income other than tax revenue, such as fees or transfer payments from the Federal government. Revenue bonds, however, may still qualify as full faith and credit bonds under § 615.5140(a)(10) if another obligor with general powers of taxation (including property taxation) has unconditionally promised to make funds available to cover all payments on such obligations. For example, if fee income is the only source of revenue for a governmental authority that operates public airports, its revenue bonds are not eligible investments under § 615.5140(a)(10). However, if a State or local government which possesses general taxation powers unconditionally pledges to make funds available to cover all payments of the bonds issued by the airport authority, these debt obligations become eligible investments under § 615.5140(a)(10). Industrial revenue bonds do not qualify as full faith and credit bonds under § 615.5140(a)(10) because private-sector obligors, and not the governmental authority, are ultimately responsible for paying the investors.

The FCA believes revenue bonds that are not backed by general taxing powers of a governmental obligor are too diverse to be effectively covered by § 615.5140(a)(11). For this reason, the FCA continues to explore other regulatory approaches for these revenue bonds in its rulemaking activities.

E. Clarification of the Liquidity Reserve Requirement

Currently, § 615.5134(b) requires each Farm Credit bank to separately identify all investments that it holds in the liquidity reserve that it maintains pursuant to § 615.5140(a). In response to concerns expressed by Farm Credit banks, the FCA clarifies that the segregation requirement in § 615.5134(b) does not prevent Farm Credit banks from:

1. Shifting specific investments in or out of the liquidity reserve to effectively manage risks to the bank.

2. Using investments in the liquidity reserve for managing interest rate risk.

3. Maintaining liquidity reserves in excess of 15 days but not exceeding 30 percent of total outstanding loans.

As the FCA interprets § 615.5134(b), a Farm Credit bank has the flexibility, at any time, to decide which instruments in its investment portfolio will be allocated to the liquidity reserve that it maintains pursuant to § 615.5134(a). Section 615.5134(a) requires each Farm Credit bank to maintain sufficient liquidity to fund its operations for a minimum of approximately 15 days. Moreover, Farm Credit banks should be mindful that § 615.5132 prohibits Farm Credit banks from holding investment portfolios that exceed 30 percent of total outstanding loans, and it only allows Farm Credit banks to acquire investments for maintaining a liquidity reserve and managing short-term surplus funds and interest rate risk.

Please direct any questions you may have concerning this bookletter to Laurie A. Rea, Senior Policy Analyst at (703) 883-4498 or real@fca.gov.

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[1]The existing regulation enables Farm Credit banks to invest in securities that are backed by ARMs with repricing mechanisms based on the following indices: (1) 1-year Constant Maturity Treasuries (CMTs); (2) Cost of Funds Index (COFI) of the Federal Home Loan Bank for the Eleventh District; (3) 3- and 6-month Treasury bills; (4) certificates of deposit at selected commercial banks; or (5) the London Interbank Offered Rate (LIBOR).

[2]Section 615.5140(a)(2)(iii), commonly known as the Farm Test, establishes a three-pronged test for eligible collateralized-mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and fixed-rate MBSs. These instruments are eligible investments if at the time of purchase and each quarter thereafter: (1) the weighted average life (WAL) does not exceed 5 years; (2) the expected WAL does not extend for more than 2 years assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points, nor shorten more than 3 years assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points; and (3) the estimated change in price is not more than 10 percent assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

[3] The most common hedge technique employed to remove or raise an embedded cap is to purchase interest rate caps or a strip of caps on the index rate that is used to reprice the CMO floater. Farm Credit banks may also use other hedge instruments, such as interest rate swaps or similar off-balance sheet instruments to accomplish the same objectives.

[4]"A-1" ratings are issued by Standard & Poor's Corp. Equivalent ratings by other NRSROs include "P-1" by Moody's Investors Service, "D-1" by Duff & Phelps, Inc., "F-1" by Fitch Investors Service, and "TBW-1" by Thomson Bankwatch, Inc.

Copy to: Chief Executive Officer
All Farm Credit Associations
All Farm Credit System Service Organizations

BL-040 REVISED
Providing Sound and Constructive Credit to Young, Beginning, and Small Farmers, Ranchers, and Producers or Harvesters of Aquatic Products

August 10, 2007

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Nancy Pellett
Chairman and Chief Executive Officer

Subject: Revised Bookletter 040 - Providing Sound and Constructive Credit to Young, Beginning, and Small Farmers, Ranchers, and Producers or Harvesters of Aquatic Products

I. Purpose

This updated bookletter provides guidance on interpreting the phrase "sound and constructive credit," in § 4.19 of the Farm Credit Act of 1971, as amended (Act), as well as Farm Credit Administration (FCA or Agency) regulation 614.4165, on the young, beginning, and small (YBS) farmers and ranchers mission (YBS regulation) of the Farm Credit System (FCS or System). This interpretation is important to ensure that all System institutions are fully engaged and use all available authorities to assist YBS farmers, ranchers, and producers or harvesters of aquatic products (YBS farmers) to begin, grow, or remain in agricultural or aquaculture production. The bookletter also retains the definitions for all three categories, "young," "beginning," and "small" farmers.

II. YBS Mission

Section 4.19 of the Act requires System associations to establish programs for furnishing " . . . sound and constructive credit and related services to young, beginning, and small farmers and ranchers." The YBS regulation, which implements the Act's YBS provision, requires System direct-lender associations to include, in their YBS programs, minimum components to ensure that they can successfully fulfill their YBS mission.

All agricultural producers face a significant number of challenges, including access to capital and credit; the impact of rising costs on profitability; urbanization and the availability of resources, like land, water, and labor; globalization; and competition from larger or more established farms. However, the hurdles that YBS farmers face are even greater due to their lack of an agricultural production history, inexperience in production agriculture, low capital position, or limited credit history. The System's YBS mission is therefore crucial to enabling YBS farmers to begin, grow, or remain in agricultural production and to facilitate the transfer of agricultural operations from one generation to the next.

III. YBS Definitions

The following definitions are the same as those adopted by the Agency when this bookletter was originally issued, December 1998, with the exception of referring to young, beginning, and small *farmers* instead of *borrowers* . The categories remain separate and distinct, and a loan to one borrower may meet the definition for any or all of the categories, but a loan does not have to meet all three to be considered a loan to an YBS farmer.

Young farmer: A farmer, rancher, or producer or harvester of aquatic products who is age 35 or younger as of the loan transaction date.

Beginning farmer: A farmer, rancher, or producer or harvester of aquatic products who has 10 years or less farming, ranching, or aquatic experience as of the loan transaction date.

Small farmer: A farmer, rancher, or producer or harvester of aquatic products who normally generates less than $250,000 in annual gross sales of agricultural or aquatic products.

Additional direction on these definitions is included in the call report instructions provided by the Agency each year to all System institutions.

IV. Providing Sound and Constructive Credit to YBS Farmers

What is sound and constructive credit?

The agricultural operations of most YBS farmers require a significant amount of diversity in income and assets (a combination of agricultural and nonagricultural) for the total operation to remain viable. Therefore, to address the needs of this critical group of System borrowers, sound and constructive credit is defined as credit that is used by YBS farmers to begin, grow, or remain in agricultural production. Sound and constructive credit may include credit for nonagricultural as well as agricultural purposes.

Credit parameters for bona fide farmers

FCA regulation 613.3000(a)(1) defines a bona fide farmer as "a person owning agricultural land or engaged in the production of agricultural products . . . " FCA lending objective regulation 613.3005 envisions financing the full credit needs of full-time farmers, and more conservative agricultural credit and restrictive nonagricultural credit for less than full-time farmers. The regulation also envisions only agricultural credit for those bona fide farmers whose business is essentially other than farming.

Determining a YBS farmer's commitment to agricultural production

The degree to which an YBS farmer is engaged, or intends to be engaged, in agricultural production determines the type and amount of credit that is available to the borrower. System institutions should analyze each application to determine the applicant's commitment to agricultural production and therefore the type and amount of agricultural and nonagricultural credit needed to begin, grow, or remain in agricultural production. Indicia of a borrower's commitment to agricultural production could include, but is not limited to, the following factors:

1. The degree of day-to-day involvement the borrower must have in the agricultural production operation, through either labor or management, or both, to evidence a clear commitment to agricultural production;

2. The intent of the borrower to actively engage in agricultural production, as evidenced by his education, training, experience, business plan or some other means;

3. A level or projected level of gross agricultural income or production that evidences a clear

commitment to agricultural production; or

4. The terms and structure of the loan, as well as planned use of loan proceeds, evidence a commitment to be truly engaged in agricultural production.

The foregoing and other criteria should be applied and weighed in a manner that best allows a System institution to meet the unique circumstances of each YBS farmer. For example, an applicant's lack of ownership of agricultural assets may be offset by considerable experience as a farm manager with demonstrated production responsibilities, evidencing a commitment to agricultural production. This commitment may make him or her a strong candidate for credit under the institution's YBS lending program.

Credit enhancements for YBS farmers

One of the most significant challenges for many YBS farmers with little or no agricultural income or assets is complying with an association's traditional loan underwriting standards. Typically, YBS farmers often have a combination of little or no assets to pledge as collateral, little or no historical production records, and little or no on-farm management experience. To provide sound and constructive credit under the Act's YBS mandate, the YBS regulation, and within the general parameters of FCA's lending objective regulation at 613.3005, System lenders should consider creating a program of reasonable credit enhancements and credit coordination programs for this often less financially stable, yet crucial group of farmers. Credit enhancements could include applying more flexible interest rates or fees, underwriting standards, and collateral requirements on such loans, as well as obtaining guarantees, such as Farm Services Agency guarantees.

System lenders may also want to consider a YBS lending policy that treats a subset of part-time YBS farmers as bona fide, full-time farmers. The subset would consist of those farmers with a high degree of commitment to begin, grow, or remain in production agriculture operations and a demonstrated intent to progress toward agricultural production as their primary business and vocation. The phrase "primary business and vocation" is used in FCA's lending objective rule at 12 C.F.R. § 613.3005 to define a "full-time, bona fide farmer." It is up to each association to select a method for determining who meets the definition of a full-time farmer. The determination of full-time for this subset of YBS farmers will have to be made, in most cases, using qualitative rather than quantitative criteria. Qualitative criteria could include an applicant's education, training, experience, business plan, or some other means that evidences the YBS farmer's commitment or intent to progress toward production agriculture as his or her primary vocation. Whatever method is chosen to determine who may be treated as a "full-time" farmer, it is critical that System institutions base the method on reasonable criteria. We note that the USDA's Agricultural Resource Management Survey counts full-time farmers as those operators who report farming as their major occupation.

Providing these YBS farmers with all of the credit and services available to full-time farmers would be considered another type of credit enhancement. Generally, any credit enhancement that improves an YBS farmer's prospects for success in agricultural production will be considered reasonable. Nonetheless, System lenders should consider their risk-bearing capacity in determining whether a credit enhancement, or combination of credit enhancements, is reasonable for their institution.

Setting aside capital for the YBS mission
In order to provide for the types of credit enhancements needed to adequately serve the YBS markets (which typically pose more risk), System institutions should consider setting aside capital that they are willing to put at risk to support programs that meet the credit needs of these YBS farmers. The amount of capital made available should be based on the strength of the institution's financial position, risk management tools, and safety and soundness controls. The Agency recognizes that designating capital for YBS lending will require considerable judgment by the System lender to ensure that it balances the credit needs of YBS farmers with the association's risk-bearing capacity.

Coordinating YBS credit with other entities
As required by § 614.4165(c)(3) and to reduce the risk associated with YBS programs, System lenders should consider increasing coordination with other System institutions, government agencies, and the private and public sectors to make use of all risk mitigation tools, such as state and federal loan guarantees or other such programs (both government or privately sponsored). Additionally, this regulatory section requires System lenders to develop outreach initiatives that could include, but are not limited to, using YBS advisory committees.

Sharing best practices
To ensure that all System institutions are implementing the most effective YBS programs possible, we encourage FCS institutions to share their best practices. This sharing of best practices is important to ensure that the System as a whole provides all YBS farmers the credit they need to begin, grow, or remain in agricultural production.

YBS farmers with minimal involvement in agriculture
The credit enhancements and capital designated for YBS programs are not intended to apply to those applicants *whose business is essentially other than farming*. As discussed in Agency guidance on *Other Credit Needs* in Examination Bulletin: FCA 2006-2, each System institution should include in their lending policies and procedures a reasonable definition of this phrase that could also apply to YBS borrowers.

V. YBS and Other Credit Needs Lending Policies

System institutions are strongly encouraged to review and modify their YBS policies and programs in response to the guidance in this bookletter. For example, System lenders may want to include in their YBS lending policies a description of the types of credit enhancements available to YBS farmers, as well as measurements and controls to ensure that the credit enhancements are applied to the suitable group of YBS farmers. Appropriately revised YBS policies would include:

- Expanding the criteria used to determine a full-time farmer to include those part-time YBS farmers with a demonstrated intent to progress toward farming as their primary business and vocation,

- A list of factors which must be documented in the loan file that will be used to demonstrate the YBS farmer's commitment or intent to progress toward agricultural production as his or her primary business and vocation (see indicia under *Determining a YBS farmer's commitment to agricultural production* above), and

- A set of internal controls, including an audit program, to ensure that its YBS policies and program are implemented for the benefit of YBS farmers to begin, grow, or remain in agricultural production.

The guidance in this bookletter also is intended to complement the guidance issued by the Agency on

Other Credit Needs in Examination Bulletin: FCA 2006-2. Therefore, System institutions are also strongly encouraged to amend their *other credit needs lending* policies and programs to develop different criteria for determining the amount of *other credit needs* financing available to YBS farmers. Such criteria should take into consideration the factors used to determine the degree to which a YBS farmer is engaged, or intends to be engaged, in agricultural production.

VI. <u>Examples</u>

The following examples highlight how a System lender may implement the guidance in this bookletter. These examples illustrate the types of loans that would likely be consistent with a sound and constructive YBS program. To ensure that such credit remains sound, System institutions should consider supporting such loans through the use of at-risk capital set aside to serve the YBS market or through other risk mitigation tools.

1. **Facts:** A beginning farmer applies for a $45,000 loan to rent 300 acres of corn/soybean cropland. He works for a local corn and soybean farmer and has a written agreement with his employer to rent the equipment necessary to operate this acreage. He will also market his product with his employer. His goal is to use this acreage as a way of working toward becoming a full-time farmer. His loan application includes a business plan describing how he plans to grow his business. **Analysis:** This YBS farmer does not own any assets to pledge as security, however, he has considerable farming experience in the type of operation that he is proposing to begin and an educational background in agriculture. Thus, this farmer has a demonstrated intent to progress toward farming as his primary business and vocation. **Result:** The beginning farmer could be treated as a full-time farmer. The association may need to rely more heavily on the applicant's education and farming experience to make this loan. However, this loan would likely be consistent with a sound and constructive YBS program.
2. **Facts:** A recent college graduate with a degree in Animal Science applies for a $75,000 loan to rent land, purchase cattle, and for operating funds to begin a cattle operation. The applicant worked on a cattle ranch before and during college. She will also work for the local feed dealer in town. Her loan application included a business plan describing how she plans to grow the business. **Analysis:** This YBS farmer does not own any assets to pledge as security; however, she has both education and farm experience in the cattle ranching operations she is beginning. Thus, this farmer has a demonstrated intent to progress toward farming as her primary business and vocation. **Result:** The young and beginning rancher could be treated as a full-time YBS farmer. The association may need to rely more heavily on the applicant's education and farming experience to make this loan. However, this loan would likely be consistent with a sound and constructive YBS program.
3. **Facts:** A young farmer rents 200 acres of farmland, owns his equipment, and owns a welding shop located in a rural area. His gross farm income is $12,000 and gross income from the welding shop is $60,000. He requests a $200,000 loan to refinance his high-cost, long-term debt incurred when purchasing the welding shop. He would like to expand his agricultural production acreage, but first he needs to increase his cash flow by refinancing this high-cost debt. **Analysis:** This farmer has a demonstrated intent to progress toward farming as his primary business and vocation. The income from the welding shop is critical to the growth and success of the farm and, therefore, this loan contributes to the young farmer's ability to remain in agricultural production. **Result:** The young farmer could be treated as a full-time YBS farmer, and the loan would likely be consistent with a sound and constructive YBS program.
4. **Facts:** A small farmer operates a wheat and cattle operation. He rents all his land and equipment from his father and intends to take over and grow the operation as owner once his father retires. His spouse is a licensed dentist. They apply for $300,000 to purchase the local rural dental office. The

income from this non-farm business is needed for the farmer to continue and grow his operation. **Analysis:** This farmer has a demonstrated intent to progress toward farming as his primary business and vocation. Financing this business enterprise helps both the YBS farmer diversify and grow his operation, and also helps the local rural area by continuing to provide local dental care. **Result:** The small farmer could be treated as a full-time farmer, and the loan would likely be consistent with a sound and constructive YBS program.

5. **Facts:** An applicant requests a $2 million loan from a System association to purchase agricultural land. He is classified by the association as a "beginning" farmer since this is his first purchase of agricultural land. While the property has the capacity to produce agricultural products, the borrower does not currently intend to engage in agricultural production. However, the borrower has sufficient ability to repay the loan with income generated by his nonagricultural business. **Analysis:** Although likely eligible for this System loan as a bona fide farmer due to his purchase of agricultural land, the indicia point to the conclusion that this borrower has not demonstrated intent to progress toward agricultural production as his primary business and vocation. **Result:** While this loan likely could be made, and other credit enhancements may be afforded by the association's sound and constructive YBS program, this beginning farmer should not be treated as a full-time farmer.
6. **Facts:** A small farmer requests $65,000 to purchase a 1.5 acre rural plot of land near a large metropolitan area and $1,000 in operating funds for inputs and equipment to grow fruits and vegetables. The applicant is an immigrant to the United States who works in construction and sells produce at farmers' markets on the weekends. He would like to grow his small farm business by purchasing small plots of land as he can afford them with the intention of moving out of construction except as needed to supplement his farm income. Produce sales currently bring in a modest annual income of approximately $5,000. **Analysis:** This farmer represents a growing trend in agriculture that is seeing immigrants getting into small and specialized agricultural production operations. Although currently the farmer is working in construction, he has demonstrated an intent to progress toward farming as his primary business and vocation through his serious commitment to agricultural production. **Result:** The small farmer could be treated as a full-time farmer, and the loan would likely be consistent with a sound and constructive YBS program.
7. **Facts:** A young and beginning farmer who has a small general law practice in a rural town requests a $150,000 term loan to begin a vineyard operation on the property owned by his parents – property that he will one day inherit – that is located in his community. The income from his small practice annually nets $45,000. He also requests a $30,000 term loan for improvements to the law practice. The applicant, who has been nurturing a serious interest in grape varieties, wines, vineyards, and wine regions for a number of years, intends to spend a portion of each day running the day-to-day operation. As his wine business grows, he intends to devote less and less time to his legal practice. His business plan, submitted with the loan application, describes how he intends to implement his vision of developing a successful and prestigious label that will offer a variety of red and white wines. **Analysis:** Although he his currently practicing law, this applicant has a demonstrated intent to progress toward farming as his primary business and vocation. The income from his law practice is critical to his entrance into the winemaking business, so providing him with financing for his legal needs as well as his agricultural needs will help him sustain and grow his winemaking operation. **Result:** The small and beginning farmer could be treated as a full-time farmer, and these loans would likely be consistent with a sound and constructive YBS program.

BL-043 REVISED
Guidance on Farm Credit Bank and Association Nominating Committees

March 8, 2007

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Bookletter #043 Revised – Guidance on Farm Credit Bank and Association Nominating Committees

One of the most important contributions that a Farm Credit System (System) bank or association stockholder can render is service as a member of his or her institution's nominating committee. It is through this service that member-owners influence the institution's commitment to good governance. This bookletter, through a question-and-answer format, provides guidance to Farm Credit banks and associations on organizing their nominating committees. It also provides guidance on a nominating committee's authority in selecting a slate of candidates for all open stockholder-elected director positions and the permissible activities of directors, officers, employees, and agents in working with nominating committees.

Organizing a Nominating Committee

1. Are nominating committees required for all Farm Credit bank and association director elections?

Yes. The Farm Credit Act of 1971, as amended (Act), at section 4.15, requires System associations to have nominating committees to nominate eligible candidates for all stockholder-elected director positions. The Act also provides for the Farm Credit Administration (FCA or Agency) to issue rules governing the election of Farm Credit bank directors. In 2006, the Agency issued FCA regulation § 611.325 to regulate the associations' use of nominating committees and to require Farm Credit banks to use nominating committees in electing their directors.[1]

2. How are nominating committees formed?

Although not required, a nominating committee charter is the best place to address the formation of the committee, number of committee members, selection of alternate members, and the general eligibility requirements for committee membership. A charter normally outlines the duties and responsibilities of, and resources available to, the nominating committee and must be consistent with current law and regulations. Effective committee charters also address recusal procedures, oaths of office and confidentiality requirements, committee duties in response to interim board vacancies, and selection of committee members.

Alternatively, Farm Credit banks' and associations' boards of directors may adopt bylaw provisions or written policies and procedures to describe how nominating committee members are identified. Policies and procedures might also provide for electing alternates to the nominating committee to ensure that the regulatory minimum of three members is always available to carry out committee responsibilities.

3. Who is eligible to serve on a nominating committee?

Our rules require the voting stockholders of an association or Farm Credit bank to elect all nominating committee members. The stockholders of a Farm Credit bank or association may not elect an individual to serve on its nominating committee who, at the time of election to, or during service on, its nominating committee, is an employee, director, or agent of the institution. This means that nominating committee members will be voting stockholders of the association, or, with Farm Credit banks, authorized representatives from the stockholder associations.[2] An institution's written policies on impartiality in elections and conflicts of interest may affect eligibility for the nominating committee because nominating committee members are subject to those same policies. Additional eligibility requirements may include being a stockholder in good standing or having knowledge of a director's duties within the institution.

4. How are nominating committee candidates identified?

Candidates may be identified through floor nominations at annual meetings, names submitted via an institution's Web site (as long as other means are available that do not require electronic access), telephone voice mail, or other nominating procedures. While institutions may use their staff to help identify nominees for nominating committee membership, an institution's officers and employees should exercise caution to ensure that they do not directly or accidentally influence the process. A nominating committee is a committee of voting stockholders, acting on behalf of the institution's stockholders; therefore, directors or management of the institution should not name candidates for, or appoint members to, the nominating committee. Election to the nominating committee is best treated as a competitive process in which stockholders may name themselves or other stockholders as candidates for the committee. The voting stockholders of each Farm Credit bank will, by necessity, involve directors of those stockholder associations or other voting entities (eligible cooperatives in the case of CoBank) in identifying potential committee members.

5. How is the election of nominating committee members conducted?

Institutions are expected to follow the rules on voting procedures contained in FCA regulations §§ 611.330 and 611.340 in electing nominating committees. Farm Credit banks and associations may also, but are not required to, provide for floor nominations for nominating committee members. Farm Credit banks and associations will also have to identify the manner in which results of the election for nominating committee members is provided to stockholders.

Institutions may not simultaneously elect a nominating committee and ask that committee to simply endorse the director candidates being elected on the same ballot. The newly elected committee will be responsible for identifying director candidates for the next director election, thus allowing the nominating committee sufficient time to identify, review the qualifications of, and develop the slate of director candidates.

6. What election procedures must associations follow in electing nominating committee members?

Section 4.15 of the Act requires that each association's nominating committee members be elected at the annual meeting to serve a one-year term of office. Our rules allow association nominating committee members to serve subsequent terms, so association committee members may stand for reelection at the next annual meeting. If in-person voting does not take place at the meeting, nominating committee members are elected by mail ballots following the annual meeting (that means using the same procedures as for director elections). Association charters, bylaws, policies, or procedures will need to specify whether nominating committee members are elected on a regional basis (similar to director candidates) or at large (all voting stockholders are allowed to vote on the election of all committee members).

7. What election procedures must Farm Credit banks follow in electing nominating committee members?

Under our rules, a Farm Credit bank's nominating committee is elected by its voting stockholders, but banks are not required to elect their nominating committee at their annual meetings nor limit committee membership to a one-year term. However, Farm Credit Banks must use weighted voting procedures, with no cumulative voting allowed, when electing members to serve on a nominating committee.

8. What information is provided on candidates for membership on a nominating committee?

It is appropriate for Farm Credit banks and associations to provide voting stockholders with the names of candidates for the nominating committee and a brief background on the committee candidates (as long as all candidates are treated equitably). Associations may want to include the region of the institution's territory the candidates represent if the nominating committee members are either nominated or elected by region, and banks may want to identify the association with which a candidate is affiliated. Institutions may include the information on the candidates for membership on the nominating committee in the Annual Meeting Information Statement (AMIS). If so, the AMIS should also explain the nominating and voting procedures to be used to elect the nominating committee for the coming year.

9. When do nominating committee members need to recuse themselves?

Nominating committee members should recuse themselves whenever their participation in committee activities presents a conflict of interest or the appearance thereof. For example, a nominating committee member who has a family member that is seeking election to the board may have to recuse him or herself from the nomination process. Further, a nominating committee member may not be a director candidate in the same election for which the committee is identifying nominees. Recusals may leave the institution with fewer than the needed three committee members, so establishing alternate members or increasing the size of the committee beyond the minimum is encouraged.

10. May nominating committee members receive pay or reimbursement from the institution?

Yes, but institutions should proceed with caution. Institutions may adopt nominating committee policies under § 611.320 that allow paying nominating committee members a reasonable fee or providing repayment for actual expenses. Institutions considering such payments are encouraged to address how the pay is determined and to ensure that payments are provided in a nondiscriminatory manner to all members.

Nominating Committee Duties and Authority

11. How does a nominating committee find two candidates for an open stockholder-elected director position?

FCA regulation § 611.325(c) requires each institution to provide its nominating committee with a current list of stockholders in the institution. A nominating committee is expected to use this list to fulfill its duties in finding willing nominees representing all areas of the institution's territory and, as nearly as possible, all types of agriculture practiced within the territory. FCA rules also require providing nominating committees with the institution's current bylaws and director qualification policies to aid the committees in identifying potential director candidates.

While at least two candidates for each open stockholder-elected director position is expected, it may not always be possible to identify two candidates. In those situations, the nominating committee must provide a written explanation to its institution's board, describing its efforts to find at least two willing candidates and the reasons for disqualifying any other candidate that resulted in fewer than two nominees. A summary of this explanation must be included in the AMIS.

12. What if a nominating committee is having trouble finding two candidates for an open stockholder-elected director position?

Institutions may allow use of their Web sites or a telephone message center to collect names of individuals interested in becoming directors. Farm Credit bank and association policies and procedures adopted under FCA regulation § 611.320 may allow employees or agents to aid the nominating committee in finding qualified and willing candidates. This opportunity must be available to any employee and not be confined to senior officers. We discuss the parameters of this assistance further below.

13. Do incumbent directors seeking reelection have to go through the nominating committee process?

Yes. The nominating committee is the only committee within a Farm Credit bank or association allowed to select a slate of candidates for each open stockholder-elected director position. The nominating committee's task is to nominate those individuals whom it decides best meet the needs of the stockholders and the board of directors. All individuals interested in election (or reelection) to a Farm Credit bank or association board of directors, except floor nominees, may only be placed on the ballot if nominated by the institution's nominating committee. Incumbent directors may submit their own names to the nominating committee, similar to how other stockholders do, to express their interest in running for reelection. Incumbent directors do not receive special exemptions from the nomination process nor may institutions require their nominating committees to nominate incumbents. However, incumbent directors may be nominated from the floor.

14. Do floor nominees for open director positions have to go through the nominating committee process?

No, as mentioned in the answer to question 13, floor nominations are the only exception to the nominating committee process. However, FCA regulation § 620.21(d)(5) provides that floor nominees must still satisfy director eligibility requirements and make the required director candidate disclosures before voting takes place. It is not necessary for the ballot to identify how a candidate was nominated.

15. Does a nominating committee have a role to play when a board is downsized?

Yes. It is important to note that even if the board agrees to a downsizing plan, it must be structured to provide for the election of at least one director each year based on directors' staggered terms. Thus, it remains the responsibility of the nominating committee to select the slate of candidates for the open director position, and this decision may not be transferred to the board or any other party. As noted above, this authority does not prevent an eligible stockholder from seeking a floor nomination and pursuing his or her candidacy independently of the nominating committee's slate of candidates.

16. Does a nominating committee identify director candidates for mid-term board vacancies?

Maybe. At a minimum, each board must consist of at least 60 percent stockholder-elected directors. Should a mid-term vacancy occur that would reduce the number of stockholder-elected directors to fewer than 60 percent of the board, the nominating committee would need to reconvene to identify nominees for the vacancy, and a special election would need to be held. If the mid-term vacancy does not affect this 60 percent minimum requirement, then the board may choose to appoint a director, which means the nominating committee would not be involved in filling the vacancy.

<u>Permissible Activities of Directors, Officers, Employees, and Agents</u>

17. May the institution's board of directors help the nominating committee find director candidates?

Yes, directors may suggest names of potential candidates for director positions to the nominating committee; however, directors should not be the only source used to identify potential candidates. Directors may also invite their nominating committee members to attend a board meeting so the committee can gain a clearer understanding of the role of the board in an institution's operations or discuss their views on the roles of the board with the nominating committee. Directors may also attend local gatherings to promote the benefits and rewards of board service and encourage voting stockholders to make themselves available as potential candidates for directors or as candidates to serve on the nominating committee. The board should use caution to avoid activities that could be construed as influencing the nominating committee's vote on its slate of candidates, particularly those directors seeking re-election to the board. No director may be present when the nominating committee deliberates or votes on its slate of candidates.

18. May institution officers, employees, or agents provide names of potential director candidates to the nominating committee?

Nominating committee policies and procedures adopted under FCA regulations § 611.320 and § 611.325 may permit employees and agents to provide names of potential director candidates to the nominating committee, but this opportunity must be available to any employee and not be confined to senior officers. If requested by the nominating committee, management may provide a list of the institution's advisory committee members or any other persons with grassroots connections to the institution from which the nominating committee may identify potential candidates. However, the board policy should remind employees and agents to avoid activities that could be construed as intended to influence the nominating committee's vote on its slate of candidates. Officers, employees, and agents cannot be present when the committee deliberates or votes on its slate of candidates. In addition, a board's policy and procedures may include giving the nominating committee biographies, resumes, and/or loan payment status (i.e., whether the potential candidate's loan is current) on potential candidates. If board policy permits this type of assistance to the nominating committee, then the board should direct officers, employees and agents to provide the assistance requested by the nominating committee.

19. What other activities are permissible for officers, employees, and agents?

Bank and association written procedures may permit officers, employees, or agents to aid the nominating committee in finding qualified and willing candidates. Such activities may include discussing with the nominating committee the functions of the board, needed skills and expertise, time requirements to serve on the board, minimum attendance at board meetings, and mandatory training required of directors. If the board permits these activities, then it should direct officers, employees, and agents to perform these activities when requested by the nominating committee.

FCA has published a pamphlet, "The Role of Farm Credit System Nominating Committees," which is designed to help stockholders and prospective nominating committee members understand their responsibilities. We encourage banks and associations to make the pamphlet available at all headquarters and branch offices. It is also available at FCA's Website at www.fca.gov (look under Resources for the FCS).

[1] Farm Credit banks' compliance with FCA regulation § 611.325 is delayed until April 5, 2007.

[2] CoBank, ACB (CoBank) also has voting stockholders that are other than System associations and may therefore have nominating committee members that are representatives of the voting stockholder associations or other voting stockholders.

Copy to: The Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

BL-049
Adequacy of Farm Credit System Institutions' Allowance for Loan Losses and Risk Funds

April 26, 2004

To:	The Chairman of the Board The Chief Executive Officer All Farm Credit System Institutions
From:	Roland E. Smith, Chief Examiner Office of Examination
Subject:	Adequacy of Farm Credit System Institutions' Allowance for Loan Losses and Risk Funds

This bookletter informs Farm Credit System (System) institutions of the Farm Credit Administration's (FCA or agency) expectations regarding the process used to determine the adequacy of their allowance for loan losses (ALL) and risk funds. This bookletter provides guidance to System institutions on principles for maintenance of an adequate level of the ALL to ensure prudent risk funds management. With the issuance of this bookletter, the agency's objective is to establish minimum criteria that each System institution should consider in its process used to determine the adequacy of its ALL and risk funds. Thus, the criteria communicated in this bookletter will be used by FCA examiners to evaluate the process a System institution uses to determine the adequacy of its ALL and risk funds. This bookletter also identifies key elements of sound business principles and practices for risk funds management by System institutions.

Background Information

For many years, the Securities and Exchange Commission (SEC) and the other Federal banking agencies[1] have provided guidance concerning their expectations regarding the ALL and related documentation. Most recently, in July 2001, the SEC issued Staff Accounting Bulletin (SAB) No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues, and the other Federal banking agencies issued an Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (Interagency Policy Statement). Both the SEC's and the other Federal banking agencies' guidance focused significant attention on the level of documentation needed by lenders in order to support the amounts in their ALL accounts. SAB No. 102 and the Interagency Policy Statement reflect a continued refinement of accounting guidance that has served to shape industry and System practices in this area.

[1] We refer collectively to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision as the "other Federal banking agencies."

To date, the agency has issued only limited formal guidance to System institutions on their ALL process. Section 621.5 of our accounting and reporting regulations set forth the agency's only regulatory requirement addressing the ALL of System institutions. This regulation, which was originally adopted in 1986, provides only the broad guidance that "[e]ach institution shall maintain at all times an allowance for loan losses that is adequate to absorb all probable and estimable losses that may reasonably be expected to exist in the loan portfolio" and "[d]evelop, adopt, and consistently apply policies and procedures governing the establishment and maintenance of the allowance for loan losses . . . ." The only other substantive agency guidance is an examination directive issued in June 1986. This directive outlines factors that the agency believes System institutions should consider in the evaluation of their ALL. The guidance in the directive is also very broad in nature. The intent of both the regulation and directive essentially was to have System institutions follow generally accepted accounting principles (GAAP).

Until now, the agency has not issued any formal guidance to System institutions with regard to our expectations for their risk funds management practices. The ALL represents a significant component of almost every System institution's risk funds. Thus, our examiners routinely evaluate a System institution's level of risk funds (i.e., ALL and capital) to assess its overall risk-bearing capacity. While the other Federal banking agencies' Interagency Policy Statement does not address risk funds, the guidance on risk funds management in this bookletter tracks best business practices with regard to boards of directors and management responsibilities.

Criteria for the ALL and Risk Funds Process

When a System institution determines the adequacy of its ALL and risk funds, we expect the process it uses to consider the following criteria:

I. <u>FCS Board of Directors' Responsibilities</u>

Effective board oversight of an institution's ALL determination is one of the keystones of a sound risk funds management process. Such oversight is crucial to a board's understanding of the process by which the institution estimates the losses inherent in the loan portfolio and determines that the level of its ALL is adequate. To properly fulfill its responsibilities, a board should at a minimum:

- Take measures to ensure its understanding of how the adequacy of the ALL relates to the overall business strategies of the institution, including those that relate to risk funds management;

- Direct management to develop and maintain appropriate policies, procedures, and internal controls that specifically address the institution's unique goals, systems, risk profile, personnel, and other resources necessary to identify the institution's exposure to loan losses and to ensure that an adequate level of the ALL and overall risk funds are continuously maintained to safeguard the institution against financial risks;

- Oversee and monitor the ALL process by ensuring internal controls are in place to consistently determine the institution's ALL in accordance with its policies and procedures and GAAP, including policies for recognition of impaired and nonaccrual loans and for recording loan charge-offs and recoveries;

- Direct management to develop documentation standards that require appropriate written supporting documentation for its ALL adequacy determination, build discipline and consistency into the ALL determination process, and ensure that all relevant factors are appropriately considered in the ALL analysis;

- Preclude management from implementing ALL methodologies that would allow the institution's earnings to be inappropriately manipulated;

- Review management's analysis and basis for its determination of the adequacy of the institution's level of the ALL in conjunction with its overall risk funds determination, including the basis for the institution's ALL methodologies and any revisions to the methodologies and/or overall process;

- Provide appropriate oversight, either directly or through a board-established audit committee, of the ALL process, including coordination and communication with the institution’s independent qualified public accountant having audit responsibilities with respect to the institution’s ALL process;

- Review and approve the overall level of the institution's ALL, including additions and reductions in its level and approval of any reductions of overall risk funds; and

- Ensure the institution is in compliance with FCA's regulatory requirements, the institution's policies, procedures, and internal controls, GAAP, and other applicable guidance that pertains to the maintenance of an adequate level of the ALL and prudent risk funds management.

II. Management's Responsibilities

Management is responsible for ensuring that the institution's risk funds are properly managed. Management should at a minimum:

- Develop and maintain procedures that translate the board's major business strategies and policies addressing the adequacy of the institution's risk funds into appropriate performance standards and expectations for risk funds management;

- Ensure the methodologies for determining the adequacy of capital, the ALL, and overall risk funds remain appropriate for the institution;

- Perform periodic reviews of the institution's lending and loan review functions;

- Maintain a record of its analysis and the basis for its determination of the adequacy of the institution's overall risk funds, including an assessment of capital and the ALL levels;

- Implement and maintain a management information system that appropriately tracks information necessary to assess the adequacy of the institution's risk funds; and

- Establish proper internal controls and audits of the risk funds management process.

Management should assess the adequacy of the institution's ALL on a regular basis but not less than quarterly. If management determines that the level of the institution's ALL is inadequate or excessive, a provision or reversal should be made to the ALL to assure the accuracy of financial statements. Likewise, management should ensure that loan losses are charged off to the ALL at the time a determination is made that a loan or portions thereof are known to be uncollectible and that recoveries are appropriately recognized when realized.

III. Methodologies

System institutions are expected to develop and document systematic methodologies to determine their ALL and related provisions for loan losses. Crucial to sound ALL methodologies is that they incorporate management's current judgments about the credit quality of the institution's loan portfolio through a disciplined and consistently applied process. It is important that the methodologies achieve a high level of correlation between changes in the level of the ALL and significant favorable or unfavorable trends in the quality of the loan portfolio. An institution's methodologies should be influenced by and tailored to entity-specific factors, such as the institution's size, organizational structure, business strategy, economic environment, management style, staff experience, loan portfolio characteristics, loan administration procedures, information systems, and internal controls.

While different institutions may use different methods, there are certain common elements that should be included in any methodologies to be considered effective. Each institution's methodologies generally should:

- Include a detailed analysis of estimated losses in the loan portfolio performed on a regular basis but not less than quarterly;
- Consider all loans (whether on a individual or group basis);
- Identify loans to be evaluated on an individual basis under Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, and segment the remainder of the loans (those that will not be individually evaluated) into groups of loans with similar characteristics for evaluation under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*;
- Consider all relevant qualitative and quantitative factors that may affect loan collectibility including the risks associated with lending in a single sector;
- Be applied consistently but, when appropriate, modified for new factors;
- Consider the overall quality of the institution's credit review programs, the concentrations of lending in a single sector, and the overall quality and experience of management;
- Place emphasis on sound management judgment;
- Consider relevant observable data;
- Review historical loan loss experiences, taking into account current conditions;
- Consider the particular risks inherent in different kinds of lending, including changing government policy regarding agricultural subsidies and the volatility of the agricultural operating environment;
- Consider collateral values, repayment patterns, and off-farm sources of income;
- Require that the methodologies function be performed by competent and well-trained staff;
- Include an analysis of deterioration in concentrations of credit, classes of borrowers, and pledged collateral based on volume and type of loans;
- Give consideration to current economic conditions and trends in delinquencies and nonaccruals;

- Include an analysis of recent trends in portfolio volume, maturity, and composition;
- Be based on reliable data;
- Include clear explanations of the supporting analyses and rationale; and
- Include a systematic and logical method to consolidate losses.

IV. Documentation Standards

Documentation is critical to an institution's ALL process in that it provides evidence that its ALL is consistently maintained at an adequate level. Appropriate written supporting documentation for an institution's ALL facilitates the loan loss review process, builds consistency into the determination process, and ensures that all relevant factors are considered in the analysis process. An important part of the ALL process is that there is documentation supporting the relationship between the findings of the detailed review of the institution's loan portfolio and the level of the ALL and related provisions reported by the institution. An institution should establish documentation standards that address the following elements:

- Policies and procedures for the process, including an internal control system to ensure the integrity of the process;
- ALL methodologies and related validation process;
- Accounting policies for loans and loan losses, including policies for charge-offs and recoveries and the fair value of collateral, where applicable;
- Roles and responsibilities of staff and departmental units, including the lending function, credit review, financial reporting, internal audit, board and management, audit committee, and others, as applicable, who determine or review the level of the ALL reported in the institution's financial statements;
- Adjustments to the ALL process and methodologies;
- Loan-grading system and process; and
- Summary or consolidation of the ALL amounts.

V. Internal Controls

For safe and sound operations, each institution should maintain an internal control system over its ALL process. Sound internal controls will ensure that the institution's ALL process is reasonable, the level of the ALL is maintained in accordance with GAAP, and prudent risk funds management practices are in place. A sound internal control system should:

- Include measures to provide assurance regarding the reliability and integrity of information used in the ALL process;
- Assure compliance with relevant laws and regulations, internal policies and procedures, GAAP, and

other applicable guidance;

- Include a review of the documentation that supports the ALL methodologies and process for completeness and sufficiency;

- Include a well-defined loan review process that contains an effective loan-grading system, ensures that all relevant loan review information is appropriately considered in estimating losses, and provides clear formal communications and coordination among all parties within the institution who are involved in the ALL process;

- Provide for an audit of the ALL process and the adequacy of the level maintained by a qualified public accountant who is independent of the institution; and

- Reasonably assure that the level of the ALL is adequate to cover the losses inherent in the institution's loan portfolio and is maintained in accordance with GAAP.

VI. FCA's Examination

FCA examiners will assess the adequacy of an institution's ALL and overall risk funds based on evaluation of the overall processes in use by the institution. The assessment will focus on the institution’s policies, practices, internal controls, documentation, methodologies, and other tools used to determine the adequacy of its ALL and overall risk funds. The performance results of an institution's risk funds management process will be considered when evaluating risk exposure levels in accordance with the FCA's Financial Institution Rating System.

This bookletter endorses the guidance issued by the SEC and by the other Federal banking agencies. The agency believes the guidance in this bookletter for the ALL, like the SEC's SAB No. 102 and the other Federal banking agencies' Interagency Policy Statement, is consistent with GAAP. In addition, the agency is issuing an examination bulletin (attached to our Informational Memorandum dated April XX, 2004) that establishes further direction for the agency's examination focus on System institutions' methodologies and documentation needed to support the ALL.

If you have any questions about this bookletter, please contact me at (703) 883-4160, or correspond with me on the Internet at e-mail address *smithr@fca.gov,* or Tom Holland, Special Examination and Supervision Division, Office of Examination, at (703) 883-4484, or correspond with him on the Internet at e-mail address *hollandt@fca.gov.*

BL-051
Maximum Director Compensation for 2006

December 15, 2005

To:	Chairman, Board of Directors Chief Executive Officer All Farm Credit Banks
From:	Nancy C. Pellett Chairman and Chief Executive Officer
Subject:	Maximum Director Compensation for 2006

The members of the Farm Credit Administration (FCA) Board recognize the increased responsibilities, expertise, and time spent on board activities by Farm Credit System (FCS or System) bank directors. For safety and soundness reasons, we believe it is important that these directors be adequately compensated for their efforts. Adequate and appropriate compensation should reflect the significant nature of bank directors' fiduciary duties and responsibilities. Adequate compensation is also critical to attract qualified individuals to consider serving as bank directors. As discussed below, compensation for FCS bank directors is limited by statute and FCA regulations. However, the statute and regulations provide the FCA Board the authority to waive the limit for exceptional circumstances or to adjust compensation limits for safety and soundness reasons.

The Farm Credit Act of 1971, as amended, states that "the Farm Credit Administration shall monitor the compensation of members of the board of directors of a System bank received as compensation for serving as a director of the bank to ensure that the amount of the compensation does not exceed a level of $20,000 per year, as adjusted to reflect changes in the Consumer Price Index for all urban consumers published by the Bureau of Labor Statistics, unless the Farm Credit Administration determines that such level adversely affects the safety and soundness of the bank." The FCA Board finds that System bank director duties and responsibilities are an integral component to ensuring the safety and soundness of Farm Credit banks. Importantly, these duties and responsibilities have increased substantially over time. The increase in duties and responsibilities are associated with regulatory- and market-driven governance and reporting and disclosure requirements in an increasingly complex and sophisticated financial services sector, as well as an agricultural sector that is increasingly driven by technological change. Fulfillment of these increased duties and responsibilities is vital to the continued safety and soundness of System banks and related institutions.

Based on the comments we received in connection with our solicitation on Farm Credit bank director compensation, and data received and analyzed by the Agency, we have determined that this correlation between Farm Credit bank director duties and responsibilities and safety and soundness requires a one-time adjustment to the current limitation on director compensation. It is a matter of record that Farm Credit bank director compensation was capped at a level approximately 18 percent below that of commercial bank directors in 1992. Since that time, inflationary adjustments have increased the cap on System bank director compensation from $20,000 to $27,060, or approximately 35 percent. Comparable commercial bank director compensation has also risen due to inflation, but it has risen more dramatically due to legislative changes and investor expectations that increased director duties and responsibilities, out of concerns for bank safety and soundness. We estimate this latter effect has caused a 93 percent increase over the same time period.

During this time period, Farm Credit bank director compensation has not risen at all despite comparable increases in director duties and responsibilities arising out of concern for System bank safety and soundness. In addition, System bank consolidations and growth have contributed to the increasing complexity of bank operations and transactions. As a regulator, we expect a level of professionalism, commitment, and expertise on the part of System bank directors that compares favorably to commercial bank directors, notwithstanding the fact that commercial banks provide a broader range of financial services, many of which entail additional operational risk. After reviewing relevant director compensation information, we are authorizing System banks to pay fair and reasonable director compensation for 2006 at a level not to exceed $45,740 (as may be adjusted for inflation). We note that this adjustment also results in an amount that is about 18 percent below current commercial bank director compensation levels. This differential is consistent with what existed when Congress placed a cap on Farm Credit bank director compensation in 1992. As required by the Act, FCA will continue to provide annual adjustments to this bank director compensation level based on changes to the CPI.

While we believe this change is consistent with the limitation imposed by Congress in 1992, System boards will still need to assess their own unique circumstances and the demands placed upon their board members in setting director compensation levels within this authorized limitation. Under FCA regulation § 611.400, bank boards will need to modify their written policy on director compensation to explain and support a higher level of compensation for their directors.

We are not changing § 611.400 of our regulations dealing with preapproved waivers to this new limitation. We note, however, that System banks must be judicious when exercising this 30 percent waiver authority. Specifically, System banks must fully identify in their annual report, both the specific extraordinary event, or events, and the additional time and effort spent on those events that justify the higher compensation level through waiver. This justification must be provided individually for each director who is compensated under the regulatory waiver provision.

BL-052
Tobacco Buyout Lending and Investment Opportunities

January 25, 2006

To: Chairman, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Tobacco Buyout Lending and Investment Opportunities

On October 22, 2004, Congress enacted the "Fair and Equitable Tobacco Reform Act of 2004" (Tobacco Act) as part of the "American Jobs Creation Act of 2004."[1] The Tobacco Act repeals the Federal tobacco price support and quota programs, provides payments to tobacco "quota owners" and producers for the elimination of the quota, and provides an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. Tobacco quota holders and producers will receive 10 years of equal payments under a contract with the Secretary of Agriculture. The Tobacco Act also includes a provision that allows the quota holders and producers to assign to a "financial institution" the right to receive the contract payments "so that they may obtain a lump sum or other payment." On April 4, 2005, the United States Department of Agriculture (USDA) issued a Final Rule implementing the "Tobacco Transition Payment Program" (Tobacco Buyout).[2]

The Farm Credit Administration (FCA or Agency) has determined that Farm Credit System (FCS or System) institutions are "financial institutions" within the meaning of the Tobacco Act and are therefore eligible to participate in the Tobacco Buyout. FCA further recognizes that the Tobacco Buyout has significant implications for some FCS institutions and the tobacco quota holders and producers they serve. FCA believes it is essential that FCS institutions be able to provide their borrowers the option to immediately receive Tobacco Buyout contract payments and reinvest them in future business opportunities. This Bookletter explains the Agency's position on the options available to System institutions for utilizing the Tobacco Buyout to meet their borrowers' financial needs under both their lending and investment authorities.

Assignments and Successor-in-Interest Contracts

Under the USDA Final Rule, payments will be made to tobacco quota holders and producers by the Commodity Credit Corporation (CCC). The USDA Final Rule provides that tobacco quota holders and producers may assign their right to receive Tobacco Buyout contract payments to a third party (including a System institution) in two ways: (1) through an "assignment" of payments or (2) by entering into a "successor-in-interest" contract with a third party.

The following table highlights some of the differences between an assignment of payments and a successor-in-interest contract.

Assignments	Successor-in-Interest Contracts
• May be entered into at any time beginning with first payment in 2005. • May include all or part of the payments. • The tobacco quota holder or producer retains ownership of the contract and the related rights and obligations under the contract. • Are subject to administrative offset under the Debt Collection Act of 1996. • Can be revoked at any time with consent of the assignee.	• May be entered into starting with the FY 2006 payment. • Partial successor-in-interest contracts are not allowed. • The successor purchases the entire contract and all related rights and obligations associated with the contract. • If a claim is owed by the seller to the United States, the CCC will not approve the successor-in-interest contract. Therefore, the successor-in-interest contract is not subject to administrative offset. • May not be revoked. • The CCC will allow the sale of successor-in-interest contracts to another party.

How the System Can Utilize the Tobacco Buyout to Meet Borrower Needs

Option 1 - Loans

Under the System's lending authority, System institutions can make loans to eligible borrowers and accept Tobacco Buyout contract payments as a dedicated source of repayment and/or primary or secondary collateral for the loans. As with any loan, loans related to Tobacco Buyout contract payments should be made in accordance with prudent credit underwriting practices, and all credit factors should be considered. System institutions may adopt special underwriting standards for this program that take into account their borrowers' financing needs and the unique nature of lending transactions related to the Tobacco Buyout.

Option 2 – Investments

This option includes direct assignments or successor-in-interest contracts, as well as securities created from Tobacco Buyout contract payments. The FCA considers investments related to the Tobacco Buyout an important mission-related activity because such investments can provide tobacco quota holders and producers immediate access to funds to help ease their transition away from government price support for future production and to meet their current financial needs.

The FCA has determined that investments in Tobacco Buyout instruments are comparable to and share many characteristics with other obligations of the United States, its agencies, instrumentalities, and corporations authorized under FCA regulation § 615.5140(a)(1). However, we also recognize the unique nature of the Tobacco Buyout and that it will have a significant financial impact on many tobacco quota holders and producers. Therefore, we concluded that investments in Tobacco Buyout instruments should be classified separately and treated as mission-related investment activities under § 615.5140(e) that are not subject to the 35 percent portfolio cap for System bank investments under § 615.5132.

The FCA Board has approved "Tobacco Buyout instruments" as eligible investments that FCS banks, associations, and service corporations may purchase and hold under § 615.5140(e) with the following conditions:

1. "Tobacco Buyout instruments" means contracts and securities related to the Tobacco Buyout, which was established under the Tobacco Act, including:

   a. Assignments of Tobacco Buyout contract payments by tobacco quota holders and producers,
   b. Successor-in-interest contracts, and
   c. Securities backed by Tobacco Buyout contract payments, assignments, or successor-in-interest contracts.

2. Prior to purchase, each FCS institution board must adopt written policies governing their investments in Tobacco Buyout instruments in accordance with § 615.5133. Policies covering Tobacco Buyout instruments may be included in the institution's policies covering other investments. Risk limitations and investment management should be appropriate for the nature of the institution's investment activities. Internal valuation models may be utilized to determine the value of Tobacco Buyout instruments at purchase and sale. FCS institutions may also use their own internal models to determine the fair value of Tobacco Buyout instruments on a monthly basis.

3. FCS associations must obtain the approval of their funding bank prior to investing in Tobacco Buyout instruments.

4. Investments in Tobacco Buyout instruments must be maintained in a portfolio separate from other eligible investments so that they are readily identifiable.

Risk Management

Engaging in lending and investing activities related to the Tobacco Buyout may carry unique operational risks, particularly with assignment transactions. System institutions should fully understand the Tobacco Buyout regulations, contract payment procedures and requirements, and tax implications.

System institutions should ensure they have appropriate policies, procedures, and internal controls in place to effectively manage all risks associated with Tobacco Buyout lending and investing activities. System institutions should also consider developing policies to ensure that all tobacco quota holders and producers are treated fairly and equitably. All System institutions interested in investing in Tobacco Buyout instruments should establish policies that place risk limits on these investments based on their institution's risk-bearing capacity. In addition, System associations that want to purchase Tobacco Buyout instruments can only do so in amounts approved by their funding bank. FCA will evaluate the safety and soundness of Tobacco Buyout related lending and investment activities through its ongoing examination process.

Capital Treatment

Tobacco Buyout contract payments are made by the CCC and have the same contractual sanctity as other

CCC payments. Although the funding for Tobacco Buyout payments is primarily derived from assessments levied upon manufacturers and importers of tobacco products, CCC's obligation is the same as for any other CCC contract.

Our May 13 Bookletter required successor-in-interest contracts to be risk-weighted at 20 percent. After our Bookletter was issued, the CCC clarified that there are no payment contingencies for Tobacco Buyout contracts. In response, the banking regulators in November changed their risk-weighting for these successor-in-interest contracts to zero percent. Because of the changes made by the CCC and the actions of the banking regulators, *the Agency has concluded that all successor-in-interest contracts, both new and existing, should be risk-weighted at zero percent.*

Assignments of Tobacco Buyout payments are not obligations of the CCC, but rather of the borrower. Typically, assignments of all kinds are taken as collateral for loans. Tobacco Buyout payments received from an assignment are subject to borrower contingencies in ways that successor-in-interest contracts are not. For instance, the borrower's failure to pay federal income taxes may cause the association to lose all or some of the expected payments from the assignment. Our May 13 Bookletter allowed loans supported by Tobacco Buyout assignments to be risk-weighted at 20 percent. The banking regulators require loans supported by Tobacco Buyout assignments to be risk-weighted at 100 percent. *The Agency has concluded that all loans recorded on and after January 1, 2006 that are supported by Tobacco Buyout assignments should be risk-weighted at 100 percent.* However, associations have made loans secured by Tobacco Buyout assignments following our earlier guidance on risk-weighting. *The Agency has concluded that System institutions should continue to risk-weight at 20 percent all loans recorded before January 1, 2006 that are supported by Tobacco Buyout assignments*.

REVISED CAPITAL RISK-WEIGHTS

Asset Type	Recorded before Jan. 1, 2006	Recorded Jan. 1, 2006 or later
Successor-in-interest contracts	0%	0%
Loans secured by assignments	20%	100%

Additional Information

USDA has Tobacco Buyout information on their Web site at www.fsa.usda.gov/tobacco, including the tobacco transition assessment and payment regulations. USDA also plans to release supplementary Federal Register Notices and press releases to provide the public additional program details as they become available. Furthermore, it is expected that the IRS will post information on Tobacco Buyout tax implications on their Web site, including their ruling on the tax treatment for assignments and successor-in-interest contracts.

If you have questions on your permissible lending and investment activities related to the Tobacco Buyout, please contact Laurie Rea, Associate Director, Office of Regulatory Policy, at (703) 883-4232 or by email at real@FCA.gov.

[1] P.L. No. 108-357 (Oct. 22, 2004).

[2] 70 Fed. Reg. 17150 (April 4, 2005).

BL-053
Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets

February 12, 2007

To:	The Chief Executive Officer The Chief Financial Officer Each Farm Credit Bank and Association
From:	Nancy C. Pellett Chairman and Chief Executive Officer
Subject:	Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets

A Farm Credit System (FCS or System) bank asked the Farm Credit Administration (FCA or Agency) to apply a lower regulatory capital risk weight to certain loans and leases to generation and transmission and electric distribution cooperatives (electric cooperatives). This request was made pursuant to FCA's reservation of authority as defined under § 615.5210(f). Under the reservation of authority provision, if the risk weight specified in § 615.5211 does not appropriately reflect the level of risk in an asset, the FCA may, on a case-by-case basis, determine the appropriate risk weight for the asset.

Upon review and analysis of the electric cooperative industry, the FCA acknowledges the unique characteristics and lower risk profile of this industry segment. This lower risk profile is supported, in part, by the financial strength and stability of the underlying member systems, the ability to establish user rates with limited third-party oversight, and the exclusive service territories encompassing rural America -- all of which insulate the electric cooperative industry from many of the credit-related risks experienced by investor-owned utilities. The strength and lower risk profile of the electric cooperative industry are further supported by its minimal loss history and sound credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs).

Based on this industry's risk profile and our analysis, the FCA has determined that exposures to certain loans, leases, participation interests, and debt securities (Assets) of the electric cooperative industry warrant a lower regulatory capital risk weight, subject to specified conditions described herein. The revised regulatory capital treatment is specific to the electric cooperative industry. **All FCS institutions may apply the revised regulatory capital risk weight to their electric cooperative Assets as indicated in this guidance retroactive to January 1, 2007.**

Assets Subject to Lower Regulatory Capital Risk Weight

The Agency assigns exposures to electric cooperative Assets, subject to specified conditions prescribed below, to the 50-percent risk-weight category set forth in § 615.5211(c).

The Agency further assigns exposures to such electric cooperative Assets to the 20-percent risk-weight category set forth in § 615.5211(b), subject to the specified conditions prescribed below, if the Asset is rated in one of the two highest credit rating categories (e.g., AAA or AA) by an NRSRO. The risk weighting is based on the NRSRO credit rating of the specific Asset (issuance) and not the issuer rating. If an Asset has more than one NRSRO rating, the lowest rating determines whether this risk weighting applies.

Notwithstanding the guidance in this Bookletter, all asset- and mortgage-backed securities (even if they satisfy the conditions below) will remain subject to the current regulatory risk-based capital treatment under § 615.5211.

Conditions for Application of Lower Regulatory Capital Risk Weight

(1) The Asset must be risk rated 1 through 7 under the System's risk-rating model. The System has adopted standard risk ratings based on a combined risk-rating model that utilizes a two-dimensional risk rating process that includes a risk rating (1-14 in which 1-9 are "Acceptable") and a collateral-rating (Loss Given Default) measurement for each loan.

(2) Annually, the cooperative must not generate more than 20 percent of its revenues from non-core business, regardless of the risk rating or NRSRO credit rating of the Asset. This revenue test must be performed on a consolidated basis, and Assets of cooperatives that exceed this test must be risk weighted subject to the current capital regulations even if the cooperatives have no financial obligation for their controlled non-core subsidiaries.

- For generation and transmission cooperatives, non-core business is defined as any activity other than the generation and transmission of electricity and includes, but is not limited to, coal gasification and coal mining in excess of production needs for owned generation.

- For electric distribution cooperatives, non-core business is defined as any activity other than the generation, purchase, and distribution of electricity and includes, but is not limited to, such interests as gas distribution, propane sales, real estate development, and communications.

(3) For cooperatives constructing a new baseload power plant, regardless of the risk rating or NRSRO credit rating of the Asset:

- The plant must not be nuclear-powered (regardless of construction costs); and

- Construction costs must not exceed 25 percent of the cooperative's total assets. If construction costs exceed 25 percent of the cooperative's total assets, then exposures to all the electric cooperative's Assets held by a System institution must be risk weighted in accordance with the current regulations. (Note: Once the new baseload plant is placed in service, however, the cooperative will be eligible for this lower risk-weighting as long as the Asset meets all other conditions.)

Any electric cooperative Asset that does not meet the above conditions will remain subject to the current regulatory capital risk weight.

Other Matters

In the event that our periodic reviews or examinations indicate that a particular electric cooperative Asset imposes risks that are not commensurate with the risk weight specified in this guidance, or if risk(s) within the electric cooperative industry significantly changes, the FCA may require System institutions to change the assigned risk-weight category for the Asset or class of Assets. In addition, System institutions are required to maintain documentation evidencing compliance with the conditions above to receive the more favorable capital treatment.

We emphasize FCA continues to maintain its reservation of authority to determine the appropriate risk weight for any Asset that imposes risks not commensurate with the risk weight assigned. The regulatory capital treatment prescribed in this guidance is specific to electric cooperative Assets. This lower risk-weight category does not apply to any other industries or assets.

If you have questions on the guidance provided in this bookletter, please contact Laurie Rea, Associate Director, Office of Regulatory Policy, at (703) 883-4232 (or by email at real@FCA.gov) or Michael Anderson, Policy Analyst, Office of Regulatory Policy at (303) 696-9737, ext. 2081 (or by email at andersonm@FCA.gov).

BL-054
Effect of FAS 158 on Regulatory Capital

January 8, 2008

To: The Chief Executive Officer
The Chief Financial Officer
Each Farm Credit Bank

From: Nancy C. Pellett
Chairman and Chief Executive Officer

Subject: Effect of FAS 158 on Regulatory Capital

In September 2006, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158). FAS 158 requires sponsors of a single-employer defined benefit postretirement plan, such as a pension plan or health care plan, to recognize the funded status of each such plan on its balance sheet. An overfunded plan is recognized as an asset, while an underfunded plan is recognized as a liability. These over- and under-funded amounts must be recorded as adjustments to currently reported balance sheet amounts through initial and ongoing entries to the accumulated other comprehensive income (AOCI) accounts in equity capital. Farm Credit System (System) banks affected by the requirements of FAS 158 must recognize its initial effects, if any, for financial reports issued as of December 31, 2007.

The funding status of these postretirement plans will change with the market valuation of plan assets; consequently, equity capital will fluctuate. The funding status of these plans and the effect on the plan sponsor's balance sheet will provide useful information to plan participants, purchasers of System debt, and others, including the Farm Credit Adminstration (FCA). For regulatory capital purposes, though, the application of FAS 158 could make it more difficult to monitor other changes in the bank's risk-adjusted assets and regulatory capital. Consequently, <u>the FCA has determined that the denominator of the net collateral ratio should exclude the effects of the adoption and application of FAS 158.</u>[1]

The application of FAS 158 will have no effect on System institutions' permanent capital, total surplus, and core surplus calculations because FCA Regulation § 615.5207(j) already requires the exclusion from permanent capital--and, by extension, from total surplus and core surplus as well--of "the net effect of all transactions covered by the definition of 'accumulated other comprehensive income' contained in the Statement of Financial Accounting Standards No. 130, as promulgated by [FASB]." Consequently, FAS 158 would affect only "total liabilities," the denominator of the net collateral ratio.

We direct each affected Bank to exclude the effects of the application of FAS 158 from the net collateral calculation, as follows:

- file Call Report Schedule RC-J that includes the net effect of any adjustments to liabilities required by this bookletter on line 21, and

- file an addendum to Call Report Schedule RC-J that shows the accounting transactions required by FAS 158 and reconciles related AOCI adjustments with reported regulatory capital ratios.

For further information on accounting for defined benefit postretirement plans, institutions should refer to FAS 158; SFAS 87, Employers' Accounting for Pensions; and FAS 106, Employers' Accounting for Postretirement Benefits Other Than Pensions.

If you have questions on the guidance provided in this bookletter, please contact Thomas Dalton, CPA, Associate Director, Office of Regulatory Policy, at (703) 883-4460 (or by email at daltont@FCA.gov) or William Dunn, Senior Financial Analyst, CFA, CPA, Office of Regulatory Policy at (703) 883-4489 (or by email at dunnw@fca.gov).

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[1] The Federal banking agencies require their regulated entities to exclude from regulatory capital any amounts recorded in AOCI resulting from the adoption and application of FAS 158. See: Office of the Comptroller of the Currency, Joint News Release NR 2006-136, "Agencies Announce Interim Decision on Impact of FAS 158 on Regulatory Capital," December 14, 2006.

BL-055
Floor Nomination Procedures for System Associations and Banks

February 14, 2008

To:	Chairman, Board of Directors Each Farm Credit Bank and Association
From:	Nancy C. Pellett Chairman and Chief Executive Officer
Subject:	Floor Nomination Procedures for System Associations and Banks

In the election of directors, the role of the nominating committee is to present, for stockholder vote, a slate of eligible candidates for service on the institution's board of directors.[1] A floor nomination is the only other manner of nominating candidates to serve as stockholder-elected directors. This bookletter provides guidance on the procedures Farm Credit System (System) associations are expected to use in accepting nominations from the floor. Farm Credit banks that allow floor nominations should also follow the guidance provided by this bookletter.

Background

Section 4.15 of the Farm Credit Act of 1971, as amended (Act), addresses nominations for director elections. Section 4.15 requires System associations to have nominating committees and to accept floor nominations, while instructing the Farm Credit Administration (FCA) to issue regulations on Farm Credit bank director elections so a choice of nominees is assured. FCA regulation § 611.325 requires Farm Credit banks and associations to have nominating committees. Also, FCA regulation § 620.21(d)(4) requires Farm Credit banks and associations to disclose in their annual meeting information statements whether floor nominations are allowed and states that associations must accept floor nominations. We encourage Farm Credit banks to accept floor nominations as well.

Floor Nomination Procedures

The manner of conducting floor nominations is generally guided by an institution's bylaws and general corporate law principles. However, an association's general authority to administer the election of stockholder directors is subject to the specific requirements of section 4.15 of the Act. Section 4.15 requires that "[nominations] shall . . . be accepted from the floor," which is an express right granted to the stockholder that may not be unduly restricted in a way that effectively weakens it. Thus, procedures for nominations from the floor may not be unduly burdensome nor have the effect of denying voting stockholders the right to name candidates through floor nominations.

For example, a System association whose bylaws, policies or procedures require that floor nominations have signatures in support of the nomination before adding the nominee to the ballot, has converted the floor nomination into a nomination by petition, effectively denying voting stockholders the right to name candidates from the floor. Section 4.15 does not require stockholder support before a floor nomination is placed on the election ballot. Also, the recognized authority on parliamentary procedures, Robert's Rules of Order, explains that nominations from the floor are made at meetings where elections are pending and do not need a “second" before being placed on a ballot, although members may second a nomination to show support.[2]

System associations may establish other procedural requirements for director elections, such as determining that a floor nominee is willing to accept the floor nomination. Also, FCA regulations require that all nominees, including those named from the floor, be eligible for the director position for which the person is nominated and make the disclosures required by FCA regulation § 620.21(d)(1) and (d)(5).

Please contact Andrew D. Jacob, CFA, Director, or Gary Van Meter, Deputy Director, Office of Regulatory Policy, at (703) 883-4414, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov if you have any questions regarding this communication.

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[1] FCA provided guidance on the nominating committee process in BL-043 Revised (March 8, 2007).

[2] Rule 46, Robert’s Rules of Order Newly Revised, 10th edition, at 417—424 (Perseus Books (2000)).

Copy to: The Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

BL-056
Distribution of Director Candidate Information

September 11, 2008

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Distribution of Director Candidate Information

This bookletter clarifies the meaning of "campaign material" for purposes of Farm Credit Administration (FCA) regulation § 611.320(e) by differentiating campaign material from educational material. The bookletter explains that Farm Credit System (System) institutions may provide, to stockholders, supplemental material on director candidates without violating the prohibition on distributing campaign material when that material is educational in nature and all candidates have a fair and equal opportunity to provide educational material. With this guidance, the FCA is seeking to promote greater stockholder awareness and participation in the election of directors to the boards of banks and associations that are a part of the borrower-owned cooperative System.

Background

FCA regulation § 611.320(e) prohibits System institutions from distributing director candidate campaign material but allows institutions to provide voting stockholders with candidate biographies. In addition, System institutions are required to provide stockholders the disclosure information made by each candidate under FCA regulation § 620.21(d)(1) and (d)(5).[1] These rules are designed to ensure that System institutions remain impartial in administering director elections, while still providing voting stockholders with enough information to make informed choices when voting for director candidates. FCA regulation § 611.320 in particular was designed to keep System institutions free from even the appearance of endorsing or promoting a particular director candidate.

The FCA provided guidance on what might be considered campaign material in two Frequently Asked Questions (FAQs) issued for our governance rules.[2] Governance FAQ number 33 explained that a System institution may request additional candidate disclosure and biographical information on director candidates as long as it is requested from all candidates, serves a legitimate purpose, and is not campaign material. Governance FAQ number 34 explained that candidate personal statements or requests for votes would generally be considered campaign material, but information commonly found in résumés would likely be treated as biographical information.

In this bookletter we are providing additional clarification and guidance for identifying what is and what is not "campaign material" under the meaning of § 611.320(e). We are providing this clarification to ensure the interpretation of "campaign material" does not limit the distribution of appropriate information on director candidates to stockholders. The larger geographic territories of some System institutions make it unrealistic to expect stockholders to have meaningful knowledge of most director candidates without some supplemental information beyond the required disclosures. The large number of stockholders in many associations also makes it impractical or cost-prohibitive for candidates to mail or distribute information themselves.

We believe that an informed electorate facilitates good governance, but that objective must be balanced with maintaining System institutions' impartiality in director elections. All candidates must be treated by System institutions fairly and equally during the election process. Likewise, information provided to voting stockholders by the System institutions should facilitate making informed decisions. Therefore, System institutions may not distribute information to stockholders that would be considered campaign material.

Differentiating Educational Material from Campaign Material

Campaign material is information clearly intended to influence the voting decisions of stockholders, while educational material is designed to inform voting stockholders of the background, experience, and qualifications of each candidate.

Educational material is information provided by a candidate, in addition to the required disclosures under § 620.21(d)(1) and (d)(5), which does not directly promote the candidate or oppose another candidate. Educational material may describe a candidate, what he or she has done, and may include a candidate's education, background, positions held in other organizations, career accomplishments, civic and personal interests, and direct contact information. Educational material may also include the candidate's responses to questions developed by an institution when those questions are asked of all director candidates. A personal statement by the candidate that discusses his or her desire to serve as a board member or thoughts regarding the institution, would also be considered educational material, as long as the statement does not venture into the realm of campaigning.

Certain items clearly constitute campaigning, which institutions are prohibited from distributing, such as material expressly advocating the election or defeat of a candidate by using words like "vote for" or "vote against" or promising a specific benefit to voters if the candidate is elected. For example, material provided by a candidate promising to double patronage payments if he or she should win the elected office would be campaign material, while material indicating a candidate's support of a strong patronage program would be educational because it does not equate the election of the candidate to a specific result (i.e., more patronage).

Preserving Impartiality in Elections

Each System institution providing educational information to stockholders must take steps to preserve its impartiality and ensure the fair and equal treatment of all director candidates, including nominees from the floor. Those steps might include 1) developing a template for use by director candidates in submitting educational information to the institution to ensure the same set of questions is asked of all candidates; 2) establishing a word count or page limit for candidate submissions and/or responses to standardized questions; 3) providing candidate information in a neutral or unbiased sequence, such as alphabetically; and 4) naming all candidates. If a candidate fails to respond to the institution's request for educational information, the institution should either indicate that no response was received or restate the candidate's required disclosure. System institutions should also establish appropriate controls over making simple grammatical and syntactical corrections to candidates' educational material unless the institution's policy is to accept the educational material "as is." Whatever steps a System institution takes, the result must avoid the appearance that the institution is favoring or endorsing any particular candidate. All candidates, including nominees from the floor, are to be given the same opportunity to provide educational information and are to be treated fairly and equally in the process of collecting and providing the information to stockholders.

We encourage System institutions to disclose that director candidate educational material was prepared and submitted by the candidate and that the information is for educational purposes only. Institutions may also want to state that, by regulation, the institution must remain impartial and can neither endorse nor oppose any candidate. After floor nominations have closed, institutions may post candidate educational material on their Web sites simultaneously with, or immediately after, distributing the material in paper form to the voting stockholders.

As before, director candidates may continue to mail or otherwise distribute their own campaign material at their own expense.

Updating Policies and Procedures on Impartiality in Elections

Each System institution is required by FCA regulation § 611.320(a) to have policies and procedures addressing the institution's impartiality in director elections. We expect each System institution that decides to provide educational material on director candidates to revise its policies and procedures to reflect the guidance provided in this bookletter. Institutions, when modifying existing policies and procedures, must ensure that all candidates are treated fairly and without bias or favoritism, particularly in the manner in which educational material is collected and disseminated.

Information to address in revisions to policies and procedures would include 1) defining what candidate material the institution considers as educational; 2) describing the manner in which that information will be collected from candidates, processed by the institution, and distributed to voting stockholders; and 3) identifying the controls used to ensure the institution's impartiality is maintained throughout the process. The updated policies and procedures should be sufficient to ensure that the process results in no real or apparent preferential treatment of any candidates and presents no significant disadvantage to floor nominees.

The guidance in this bookletter in no way lessens FCA's expectations regarding an institution's duty to remain impartial in director elections. As such, FCA will examine each institution's policies, procedures, and actual practices against the principles of fairness, equal access, and impartiality toward all candidates.

Please contact Andrew D. Jacob, CFA, Director, or Gary Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, at (703) 883-4414, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov if you have any questions regarding this communication.

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[1] FCA regulation § 620.21(d)(6) requires that candidate disclosure information be provided to voting stockholders as part of the election process. Candidate disclosure statements, prepared by all director candidates, consist of the candidate's name, city and state of residence, 5-year business and employment history, a list of other business affiliations where the candidate serves on the board or in a position of authority, familial relationships with the institution, and adverse loan status, if any, for any institution loan held by the candidate.

[2] Available at www.fca.gov.

Copy to: The Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

BL-057
Use of State-Chartered Business Entities to Hold Acquired Property

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Use of State-Chartered Business Entities to Hold Acquired Property

Non-Farm Credit System lenders, such as commercial banks, make use of business entities organized under state law (state-chartered), primarily limited liability companies (LLCs), when managing acquired property in complex and unusual situations that may expose the lender to risks beyond those commonly associated with loans. LLCs or other state-chartered business entities are formed, for example, to hold acquired industrial or manufacturing properties (such as ethanol plants) where a lender is concerned about incurring potential environmental or other liabilities that may accrue to an owner of these types of properties. Multi-lender participation and syndication agreements may also provide for creation of an LLC to hold acquired property as a means of distributing *pro rata* interests in recovered collateral to lenders who participate in the loan transaction.

A "limited liability company" (sometimes—incorrectly—referred to as a limited liability "corporation") is a state-chartered business entity that combines certain characteristics of a corporation and a partnership. Like a traditional corporation, the LLC form limits the liability of its owners; like a partnership, it provides for pass-through income taxation. Ownership in an LLC is usually evidenced by membership interests.

Section 4.25 of the Farm Credit Act of 1971, as amended, authorizes Farm Credit System (System) institutions to form service corporations to conduct statutorily authorized activities (other than extending credit or selling insurance). System institutions may also work together through unincorporated service organizations, including joint ventures and partnerships, to engage in authorized activities. Farm Credit Administration (FCA) rules do not authorize System institutions to form or hold interests in any other type of state-chartered business entity, such as an LLC. The FCA is reviewing regulatory requirements to determine if revisions are needed to address use of LLCs or other state-chartered business entities for the limited purpose of acquiring and managing property of distressed loans that involve unusual or complex collateral.

However, as part of their statutory lending powers, System institutions clearly have the authority and the obligation to seek collection of debts from property held as collateral for defaulted loan obligations. Therefore, FCA believes that System institutions have the concomitant legal authority to take the same commercially reasonable and accepted measures as non-System lenders when acquiring and holding property as a result of a defaulted loan, including the use of tools, such as LLCs, to limit liabilities under appropriately narrow circumstances.

Therefore, FCA will not object if a System institution, acting in good faith, forms or acquires an interest in one or more LLCs or other state-chartered business entities for the limited purpose of carrying out the following activities: 1) making credit bids at a foreclosure sale or other court-approved auction of property collateralizing System institutions' loans that are in default; and

2) holding and managing acquired property to minimize losses, protect the property's value, and limit potential liability, including taking appropriate actions to limit the potential for liability under applicable environmental law and regulations.

A System institution that acquires an interest in an LLC or other state-chartered business entity for these purposes must:

1. Provide timely and early notice before acquiring any interest to FCA's Examiner-in-Charge (EIC) and provide the EIC the LLC charter or agreement upon formation of the LLC or other state-chartered business entity;
2. Ensure that any interest acquired in an LLC or other state-chartered business entity is solely for the purposes specified above and complies with all legal documentation requirements applicable to the form of the entity, as supported by opinion of outside counsel;
3. Maintain, or maintain access to, all books, papers, records, agreements, reports and other documents of each LLC or other state-chartered business entity necessary to document and protect its interest in each entity;
4. Provide FCA examiners with full access to all documents within the institution's control or access relating to its interest in an LLC or other state-chartered business entity;
5. Divest, as soon as practicable, ownership interest in (or withdraw membership from) any LLC or other state-chartered business entity that conducts activities beyond those needed to carry out the purposes specified above or conducts new business activities that the institution does not have the authority to conduct under the Farm Credit Act of 1971, as amended, (Act).
6. Report any interest in an LLC or other state-chartered business entity as acquired property on reports to its board of directors and reflect this acquired property in Call Reports as FCA directs;
7. Appropriately value acquired property pursuant to FCA regulations and Generally Accepted Accounting Principles and in consultation with the institution's EIC;
8. Dispose of the acquired property and divest its interest in an LLC or other state-chartered business entity at the earliest possible time or as directed by the FCA.

System institutions must make an independent determination regarding how and whether to acquire or manage collateral for distressed loans, including the use of LLCs or other state-chartered entities. We believe that it is generally inappropriate for FCA to provide prior approval or concurrence for these decisions. It is the responsibility of a System institution, acting in concert with any lending partners, to determine, after exercising proper due diligence and performing a comprehensive least-cost analysis, whether a bid should be made or how to acquire property. The existence of an LLC or other entity does not mitigate in any way prudent and conservative oversight and management of acquired property, including the realistic recognition of holding costs, specific allowance provisions, and establishing realistic exit strategies to dispose of the acquired property in a timely manner.

The use of an LLC or other entity is not a factor in determining the level of losses that a System institution may need to recognize on a defaulted loan and any related acquired property. The FCA will continue to exercise its full authority under the Act and its regulations to ensure that the risk in these distressed credits and any resulting acquired property is fully recognized. The FCA will be conservative and cautious in evaluating the value placed on the collateral and any related acquired property for risk and loss identification purposes. FCA's Office of Examination will closely review acquired property situations and provide any supervisory oversight and required actions that might be necessary.

The position expressed by FCA in this bookletter applies only to acquisition of an interest in an LLC or other state-chartered entity for the limited purposes specified above. A System institution acquiring an ownership interest in an LLC or other business entity under these circumstances does not provide a System institution with any authority or justification for acquiring an interest in an LLC or any other business entity for any other purpose or to perform any other activities through an established LLC or other entity.

Please contact Charles Rawls, General Counsel, or Howard Rubin, Senior Counsel, at (703) 883-4020, if you have any questions regarding this bookletter.

Copy to: Chief Executive Officer
Each Farm Credit Bank and Association

BL-058
Financing Agricultural Land in Transition (in the Path of Development) -- Eligibility and Scope of Financing Considerations

May 28, 2009

To: Chairman, Board of Directors
All Farm Credit System Institutions

Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Financing Agricultural Land In Transition (in the Path of Development) – Eligibility and Scope of Financing Considerations

This Bookletter provides guidance on how institutions should ensure compliance with the eligibility and scope of financing regulations when loan funds will be used to purchase or refinance land in transition. Land in transition is agricultural land that lies in the path of development. In some cases, this may involve land changing ownership several times before ultimately transitioning out of agriculture. Questions frequently arise concerning the application of eligibility and scope of financing regulations when evaluating an applicant's request for financing. While financing land in transition may occur, the Farm Credit Administration (FCA) has consistently directed that Farm Credit System (FCS or System) institutions may not provide development financing that converts agricultural land to non-agricultural uses, except in very rare instances.

This Bookletter also provides useful information for making other scope of financing decisions and supplements the guidance found in the Examination Bulletin FCA 2006-2. The Examination Bulletin was developed to provide examiners guidance for evaluating programs that System institutions use in meeting the other (i.e., non-agricultural) credit needs of farmers, ranchers, and producers or harvesters of aquatic products.

It is important to note that neither Examination Bulletin FCA 2006-2 nor this Bookletter were developed to address the safety and soundness risks associated with financing land in transition. The FCA plans to issue further safety and soundness guidance in this area in the near future.

Eligibility and Scope of Financing Rules

The eligibility and scope of financing rules contained in 12 C.F.R., Part 613, Subpart A, address System funding for farmers, ranchers, and aquatic producers or harvesters. More specifically, § 613.3005 addresses the System's lending objective and provides parameters for financing the agricultural and non-agricultural needs of full- and part-time farmers (see Attachment). These parameters primarily focus on the applicant's status as a full- or part-time farmer, which is determined by analyzing the totality of the farmer's existing operation and the impact of the loan request. After a System institution has completed the eligibility analysis, it is able to determine the appropriate scope of financing (i.e., amount and type) that can be offered.

Section 613.3005 of FCA's regulations specifically notes that System institutions should only finance the agricultural credit needs of an applicant "whose business is essentially other than farming." However, the factors for making these determinations are not always readily apparent, making these determinations challenging – particularly when land in transition is involved. Accordingly, this Bookletter serves to provide additional guidance for determining whether an applicant's business is essentially other than farming; whether the property purchased is agricultural land; and whether the purpose of the loan request meets an agricultural need.

Policy Guidance – Controls Over Financing Land In Transition

Scope of financing determinations must be evaluated on a pro forma or "forward looking" basis. In other words, an institution's lending staff should determine what the applicant's operation would look like if the loan is approved and funded. Therefore, System institutions should ensure their lending policies and procedures require that the following determinations be made prior to financing land in transition:

- Is the <u>person</u> (i.e., an individual, or a legal entity, which may comprise multiple owners) applying for the loan a full- or part-time farmer or an applicant "whose business is essentially other than farming?"

- Will the <u>property</u> being purchased with the loan proceeds (or refinanced) continue to meet the regulatory definition of "agricultural land?"[1]

- Will the <u>purpose</u> of the loan fulfill an "agricultural need?"

To help guide these determinations, the following sections outline more specific guidance in evaluating the person, property, and purpose.

<u>Analysis of the Person</u>

As previously noted, § 613.3005 requires that a lender make a determination about an applicant's involvement in agriculture before financing a request for credit, including those involving land in transition. An institution's eligibility and scope of financing policies and procedures should address the following considerations in making this determination:

- An appropriate and supportable definition for an "applicant whose business is essentially other than farming" should be consistently applied. Factors to consider when developing this definition include the applicant's:

    - Percentage of farm income to nonagricultural income;
    - Percentage of time devoted to the vocation of farming or ranching;
    - Percentage of agricultural assets to nonagricultural assets;
    - Education, work experience, and current employment situation; and,
    - Past experience converting land from agricultural use to residential and commercial uses.

- A close evaluation of the factors used to determine if the applicant is a person "whose business is essentially other than farming" is needed. The more tenuous an applicant's ties to farming, the greater the need for justification and supporting documentation for land-in-transition financing decisions.

- If the applicant is a person "whose business is essentially other than farming" and is involved in land development, loan approvals should be on an exception basis and only after the institution determines that the loan purpose clearly meets an agricultural need. (See **Analysis of the Purpose** section below.)

- A careful evaluation of loan requests from an existing or former borrower is needed to determine whether the applicant's operations have evolved into land development ventures. If so, appropriate scope of lending determinations must be made before any future loans can be made.

Analysis of the Property

Section 619.9025 of FCA's regulations defines agricultural land as "land improved or unimproved which is devoted to or available for the production of crops and other products such as but not limited to fruits and timber or for the raising of livestock." Determining whether the property being purchased (or refinanced) meets this regulatory definition is important in establishing the eligibility and scope of financing for an applicant. To aid in making this determination, an institution's eligibility and scope of financing policies and procedures should address the following factors:

- System institutions should carefully evaluate any application that involves a request to finance real estate in close proximity to an urban area where high per acre land values are driven by the land's future development value rather than its agricultural value.

- Financing for the purchase or refinance of land in transition for an applicant "whose business is essentially other than farming" is appropriate only when all or substantially all of the land will continue to meet the definition of agricultural land.

- FCS institutions must fully understand and document what an applicant intends to do with the property financed (or refinanced). Any indication the land will no longer be available for the production of crops or other agricultural products should remove the property from consideration as "agricultural land."

- FCS institutions must thoroughly analyze and document the overall agricultural nature of a property. Land that will be used for both agricultural and non-agricultural purposes would only meet the regulatory definition of agricultural land when the land substantially retains its agricultural nature.

- Although zoning laws vary across the country, a review of the designation (i.e., agricultural, residential, or commercial) can help an institution determine whether a property should be considered "agricultural land."

Analysis of the Purpose

An analysis of the purpose of the loan is critical to evaluating financing for less than full-time farmers. FCS institutions must fully analyze and document to what extent the loan will fulfill an agricultural need. This analysis is critically important once an FCS institution has determined that an applicant requesting a loan for land in transition is a person "whose business is essentially other than farming." An institution's eligibility and scope of lending policies and procedures should address the following issues to help lending staff make these determinations:

- FCS institutions must fully understand and document what the applicant plans to do with the property. The documentation provided by the applicant and developed by the loan officer should clearly explain and support why the loan is for an agricultural need. The institution may require that the applicant(s) sign a "statement of intent" to document future plans for farming or improving the real estate in question. Nonetheless, having a signed "statement of intent" does not eliminate the institution's responsibility to perform and document a thorough evaluation of the application based upon the totality of the circumstances (i.e., the person, property, and purpose of the loan).

- System financing of residential or commercial development projects should only be done as a policy exception, with most, if not all, exceptions reserved for full-time farmers, or upon rare occasions, those part-time farmers with significant agricultural activities, assets, and/or income. Policies should address the proper level of authority within the institution needed for granting exceptions and require periodic reporting of policy exceptions to the board or a board committee.

- System institutions should make sure that appropriate validations and controls are maintained to ensure that loan advances are not used to fund purposes associated with commercial or residential development.

- Loan terms and structures should reflect the applicant's agricultural needs. For example, requests for loans that have minimal down-payment or amortization requirements, interest-only repayment schedules, and short-term balloon payments, may suggest that the applicant's financing needs are not agricultural. When financing an applicant who is essentially other than a farmer or a part-time farmer whose real estate has a high probability of being developed, a System institution should structure the loan in a manner that provides for the institution to exit the relationship before any development occurs.

- Plans for repaying the loan should be consistent with the intended agricultural use of the property. For example, applicants that propose loan repayment from the sale of real-estate collateral or other real-estate properties may be indicating that their needs are not agricultural. Further, if projected agricultural income is minimal compared to the loan repayment terms, this may suggest that the loan does not fulfill an agricultural need.

- FCS institutions should carefully evaluate any improvements that an applicant plans to make to a property. Improvements that enhance an agricultural operation (e.g., drainage tiling, fencing, irrigation) are considered to be agricultural purposes, while improvements that enhance the property's non-agricultural appeal are considered non-agricultural purposes (e.g., paved roads, street lights, utilities).

- FCS institutions should carefully scrutinize any plans to divide a property into smaller parcels. The purchase of a large tract of agricultural land and its division into smaller agricultural tracts may be consistent with an agricultural purpose under certain very limited circumstances. As noted above, use of the property must remain predominantly agricultural and development on the property must be kept to a minimum for the loan purpose to be considered as fulfilling an agricultural need.

Decisions Based on the Totality of the Circumstances

System institutions must ensure that their policies and procedures provide adequate guidance to lending staff for the analysis of eligibility and scope of financing determinations. The analysis supporting these determinations should be documented and encompass the totality of the circumstances surrounding the loan request, including the person, property, and purpose as outlined above.

In conclusion, the guidance contained in this Bookletter does not prevent a board of directors from establishing conservative policy direction for land-in-transition financing. Each FCS institution board of directors needs to continue to evaluate its policy direction in consideration of their institution's current lending environment, risk bearing capacity, and appropriateness of land-in-transition financing for its chartered territory.

Please distribute copies of this Bookletter to your board of directors, discuss its contents, and make adjustments, as appropriate, to your policies and procedures as discussed above.

If you have any questions about the guidance contained in this Bookletter, please contact Barry Mardock, Associate Director, Office of Regulatory Policy, at (703) 883-4456 (mardockb@fca.gov), or Andrew Jacob, Director, Office of Regulatory Policy at (703) 883-4356 (jacoba@fca.gov).

Attachment

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[1] See 12 C.F.R. § 619.9025.

Attachment

PART 613 - ELIGIBILITY AND SCOPE OF FINANCING

Subpart A - Financing Under Titles I and II of the Farm Credit Act

§ 613.3005 Lending objective.

It is the objective of each bank and association, except for banks for cooperatives, to provide full credit, to the extent of creditworthiness, to the full-time bona fide farmer (one whose primary business and vocation is farming, ranching, or producing or harvesting aquatic products); and conservative credit to less than full-time farmers for agricultural enterprises, and more restricted credit for other credit requirements as needed to ensure a sound credit package or to accommodate a borrower's needs as long as the total credit results in being primarily an agricultural loan. However, the part-time farmer who needs to seek off-farm employment to supplement farm income or who desires to supplement off-farm income by living in a rural area and is carrying on a valid agricultural operation, shall have availability of credit for mortgages, other agricultural purposes, and family needs in the preferred position along with full-time farmers. Loans to farmers shall be on an increasingly conservative basis as the emphasis moves away from the full-time bona fide farmer to the point where agricultural needs only will be financed for the applicant whose business is essentially other than farming. Credit shall not be extended where investment in agricultural assets for speculative appreciation is a primary factor.

BL-059
Determining Eligibility and Scope of Financing for Limited Liability Companies

July 9, 2009

To: Chairman, Board of Directors
All Farm Credit System Institutions

Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Determining Eligibility and Scope of Financing for Limited Liability Companies

The purpose of this Bookletter is to provide answers to frequently asked questions about eligibility and scope of financing for a limited liability company (LLC). An LLC is a common legal entity being used today by America's farmers and ranchers for various reasons, including risk management and tax and estate planning. LLCs are often established by farmers and ranchers to maintain legal separation of their agricultural and nonagricultural businesses. As a result, the Farm Credit Administration (FCA or Agency) continues to receive questions regarding application of the eligibility and scope-of-financing rules to LLCs. The following *Questions and Answers* provide guidance in this area.[1]

What is a limited liability company?
An LLC is a state-chartered business entity that combines certain characteristics of a corporation and a partnership. Like a traditional corporation, the LLC structure limits the liability of its owners; like a partnership, it provides for pass-through income taxation. As in a corporation, an LLC's owners'/shareholders' personal assets are protected from claims of the LLC's creditors. Under state law, an LLC is generally considered to be a separate legal entity or "person" that can sue and be sued in its own name.

Can an LLC be an eligible borrower?
Yes. An LLC can be an eligible borrower. Under FCA rule § 613.3000(a), an LLC (and other legal entities) can qualify as a "person" eligible for financing as a "bona fide farmer or rancher" if it owns agricultural land or is engaged in the production of agricultural products, including aquatic products under controlled conditions.

Is an LLC treated like an individual for determining its eligibility and scope of financing?
Yes. An LLC is treated just like an individual for determining its eligibility and scope of financing because an LLC is considered to be a "person" for eligibility determination. Just like an individual farmer, an LLC must own agricultural land or engage in the production of agricultural products to be eligible to borrow from the Farm Credit System (System). As with any eligible borrower, determining the scope of financing depends on the level of the LLC's agricultural involvement in accordance with the scope-of-lending rule at 12 C.F.R. 613.3005.

Can an LLC formed for nonagricultural purposes borrow from the System?
It depends. An LLC that owns agricultural land but was not formed for the purpose of farming or ranching would be considered an applicant "whose business is essentially other than farming." Under § 613.3005, if an LLC's business is "essentially other than farming," financing is restricted to "agricultural needs" only. An agricultural "need" would not include developing agricultural land for residential or commercial purposes, and it would not include other nonagricultural business activities or other types of nonagricultural loan purposes.

However, if an LLC planned to purchase agricultural land and devote it to, or maintain its availability for, agricultural production, financing the purchase of the land would be considered an agricultural "need" and the LLC would be eligible to receive financing for this purpose. In this instance, just like with individual farmers whose businesses are "essentially other than farming," the loan should be structured to require it to be paid off at such time that the LLC decides to develop or use the land for a nonagricultural purpose. See FCA Bookletter BL-058, dated May 28, 2009, for additional guidance on financing land in transition.

Could an LLC receive financing for "other credit needs"?
Yes. Just like an individual farmer, if an LLC qualifies under an institution's lending policy and FCA regulations as a "full-time farmer," the LLC can receive other credit needs financing for any constructive purpose, commensurate with its creditworthiness. An LLC qualifying as a "part-time" farmer also could receive other credit needs financing, commensurate with its level of agricultural involvement. However, as stated earlier, an LLC whose business is "essentially other than farming" would not be eligible for other credit needs financing. Please refer to Examination Bulletin FCA 2006-2 for FCA's expectations regarding lending programs for farmers' other credit needs.

For determining eligibility for agricultural credit, does it matter that an LLC is owned by farmers, nonfarmers, or a mix?
No. Ownership of an LLC is of no consequence in determining eligibility when the LLC's purpose and needs are agricultural. For example, an LLC formed for the purpose of operating a crop farm would be eligible for System financing regardless of whether it was owned by farmers, non-farmers, or any combination thereof. However, as stated previously, an LLC whose purpose and only financing "need" is nonagricultural is not in itself eligible to borrow from the System.

Can a farmer's nonagricultural business interests be financed in an LLC?
Yes. A farmer may receive credit that will be used by a nonagricultural LLC, but only if the farmer-owner signs as an obligor on the promissory note. In this instance, the loan would be considered as a loan to the farmer, and the activities of the LLC would constitute the farmer's "other credit needs." The caveat, of course, as noted above, is that "other credit needs" financing must be commensurate with the farmer's involvement in agriculture and his or her creditworthiness. Without the farmer's signature, the association would be extending credit to an ineligible borrower, in violation of FCA regulation § 613.3000. While the farmer's signature on the promissory note addresses eligibility requirements, institutions must ensure that loans to the LLC are structured and underwritten in a safe and sound manner. Loans to the LLC should be underwritten with credit standards and requirements commensurate with the type of business activities and business risks undertaken by the LLC.

Would a 100 percent guarantee by a farmer on a loan to a nonagricultural LLC equate to a farmer signing as an obligor for determining eligibility?

No. We do not consider a guarantee to be the equivalent to the farmer signing as an obligor for the loan. While a guarantee can help ensure safe and sound lending, it does not provide a direct legal contract with the farmer for establishing borrowing eligibility on behalf of an LLC.

Can "farmer ownership tests" used for loans to legal entities formed for processing and marketing operations be used for determining eligibility and scope of financing for an LLC as a farmer-borrower under § 613.3000?

No. The "farmer ownership tests" under FCA regulation § 613.3010 for determining the eligibility of legal entities are only applicable to loans for processing and marketing operations. When determining the eligibility for a legal entity under § 613.3000 and the eligibility and scope of financing for an LLC outside of processing and marketing operations, one must look to the LLC itself, not to the owners of the LLC, as previously discussed.

Conclusion

In summary, an LLC is treated as a separate entity and as a separate "person" for purposes of determining eligibility and scope of financing. The owners of the LLC do not affect the LLC's eligibility or its scope of financing limitations under FCA regulation § 613.3000. The LLC itself may qualify as a "full or part-time farmer, or a person whose business is "essentially other than farming" and the scope of financing, including "other credit needs" financing, would then be determined commensurate with the LLC's involvement in agriculture and creditworthiness. In order for an association to make a loan to a farmer that would be used by a nonagricultural LLC, whose purpose and "need" are nonagricultural, the farmer-owner must sign as an obligor on the promissory note. Under such an arrangement, the activities of the LLC would constitute the farmer's "other credit needs." Additionally, the amount of "other credit needs" financing should be commensurate with the farmer's involvement in agriculture and creditworthiness. Please refer to Examination Bulletin FCA 2006-2 for FCA expectations regarding lending programs for farmers' other credit needs.

While eligibility and scope of financing issues can be effectively addressed by following the guidelines discussed in this Bookletter, an institution must also ensure that loans to LLCs are structured and underwritten in a safe and sound manner. Loans to an LLC should be conservatively underwritten with credit standards and requirements commensurate with the type of business activities and business risks undertaken by the LLC. Moreover, the institution must ensure that it has the appropriate staffing, controls, and policy framework to competently underwrite, understand, and control the risks associated with lending to an LLC.

Please distribute copies of this Bookletter to your board of directors, discuss its contents, and make adjustments, as appropriate, to your policies and procedures as discussed above.

If you have any questions about the guidance contained in this Bookletter, please contact Barry Mardock, Associate Director, Office of Regulatory Policy, at (703) 883-4456, or at mardockb@fca.gov, or Andrew Jacob, Director, Office of Regulatory Policy, at (703) 883-4356, or at jacoba@fca.gov.

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[1] This Bookletter does not apply to the financing of processing or marketing operations governed by FCA regulation § 613.3010 or to financing farm-related service businesses governed by FCA regulation § 613.3020.

BL-060
Compensation Committees

July 9, 2009

To: Chairman, Board of Directors
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Compensation Committees

In recent months the matter of executive compensation has received significant attention from government officials, members of Congress, investors, the media, and the public. The administration is now developing enhanced guidance on compensation practices at U.S. banking organizations. Compensation practices, if not managed carefully, carry significant reputation risks to Farm Credit System (System) institutions as government-sponsored enterprises (GSEs). System institutions' boards of directors and their compensation committees must ensure that they are prudently managing compensation programs, aligning compensation practices with sound operations and long-term performance, and providing, in an open and transparent manner, accurate, comprehensive, and understandable disclosures on their compensation programs and practices as § 620.5(i) of FCA's regulations requires. These disclosures are vitally important to System shareholders, the investing public, and FCA.[1]

In 2006, FCA's governance rule required System banks and associations and the Federal Farm Credit Banks Funding Corporation (institutions) to establish compensation committees.[2] The regulatory requirement is relatively new. This bookletter advances the objectives of good governance by conveying our expectations for the compensation committee's fulfillment of its obligations to the institution and its shareholders. The compensation committee's sensitivity to the current business environment and its prudent management of the institution's financial resources are essential in protecting the institution's reputation in the community and the marketplace. The committee's role is critical in safeguarding the institution's integrity at a time of heightened concern and scrutiny on executive compensation. Your board of directors should initiate an appropriate review to determine whether your compensation committee charter, your compensation committee's process and operations, and your institution's compensation disclosures align with our expectations or whether changes should be considered.

Board Responsibilities. A compensation committee will function more effectively when the committee charter clearly sets out the board's expectations on how the committee is to perform its duties. The board of directors must establish and maintain a compensation committee by adopting a written charter and appointing at least three directors to serve on the committee in accordance with § 620.31 and § 630.6(b) of FCA's regulations. In carrying out these responsibilities, the board should ensure that the charter:

- Delineates clearly the authorities the board is delegating to the compensation committee;
- Authorizes the compensation committee to hire, retain, and terminate external advisers and/or outside legal counsel needed to assist the committee in performing its duties. These professionals should work directly for, and report directly to, the committee and be independent of senior management (i.e., no personal or other professional relationships with senior management);[3]
- Authorizes the committee's direct access to any advisers that management uses on compensation programs or practices;
- Provides for the committee's easy and ready access to institution resources and personnel, particularly senior officers and managers with human resources responsibilities, to obtain needed information and gain the best overall understanding of the compensation program; and
- Requires the compensation committee to remain accountable, and report only, to the board.

The board should appoint one of the directors to chair the compensation committee. The board should also ensure that the committee members have no known or potential conflicts of interest with executive (senior) officers that could interfere with the committee members' exercise of independent judgment. Additionally, the board should be mindful of its policy on director training and revise it, if needed, to ensure that compensation committee members receive ongoing training from professionals on compensation trends and updates, including the tax, accounting, and legal implications of compensation programs. The training should provide a solid platform for the committee to evaluate and modify the compensation program with a competent and critical eye.

<u>Compensation Committee Operations</u>. The committee should have written procedures in place for its operations. The procedures should address the responsibilities of the committee chair, particularly the chair's role as the key contact between the committee and the board and between the committee and senior management. In that capacity, the committee chair should have discretion to brief the board chairman and advise him or her of any key decisions in advance so the board is prepared to deal with the issue(s) when the committee and board meet. The procedures should provide for committee executive sessions where critical issues can be discussed without management present. By regulation, the committee must keep meeting minutes and retain those minutes for at least 3 years. Meeting minutes should provide sufficient detail on reasons for decisions to avoid member disputes on prior decisions. Committee members should have ready access to past minutes for reference or review. If the entire board serves as the compensation committee, it is essential that directors, when meeting as the compensation committee, maintain a separate agenda and a separate set of minutes so the business of the board and the business of the compensation committee are not mixed. The committee should review its charter annually and recommend any revisions to the board. As a subset of the annual board self-evaluation process, compensation committee members should consider assessing their own performance as a board committee.

<u>Key Factors for the Compensation Committee to Consider in Discharging its Duties</u>. The jurisdiction of the compensation committee includes the review of the compensation policy and plan for *all* employees as well as the approval of the overall compensation program for the chief executive officer and other senior officers. Thus, the committee's reach extends to the institution's salary programs, perquisites, short- and long-term incentives, deferred compensation, retirement and/or pension programs, supplemental pension programs for senior

officers, executive employment and severance agreements, change-of-control provisions, succession planning and retention bonuses, and employee benefit plans. Consequently, we expect that the compensation committee should be able to:

- Articulate the board's compensation philosophy—what the institution rewards and why—and convey that philosophy in the annual compensation disclosure;
- Consult with, or employ as needed, professionals and/or external legal counsel who are independent of senior management and who bring the necessary perspective and expertise to work directly with the compensation committee on compensation-related issues;
- Fully analyze and justify the long-term liability to the institution in developing compensation packages and fully understand the financial commitment and total cost to the institution. Use appropriate analysis and metrics to develop a complete understanding of the full effects of the compensation package as it pertains to the chief executive officer and individual senior officers (all the elements of annual pay, long-term pay, severance benefits, and all other compensation);
- Ensure an appropriate linkage of pay to performance to ensure that total compensation packages are meaningful relative to the institution's long-term financial outcomes;
- Carefully evaluate incentive programs and ensure that incentive payments are based on the institution's long-term financial performance, are consistent with prudent risk-taking, and produce safe and sound outcomes;
- Ensure incentive programs align the interests of senior officers and employees with the long-term financial health of the institution (e.g., do not give undue weight to factors such as loan growth without also considering asset quality, profitability, and financial performance factors);
- Ensure that retirement benefits are appropriate and not excessive in light of bonus programs and other compensation already paid to executive officers;
- Ensure pension programs are appropriately structured to attract, retain, and reward staff, and that pension programs are appropriately funded; and
- Fully understand key assumptions used to calculate compensation and pension plan obligations, such as assumptions used for present value calculations, as well as the sensitivity of your institution's financial exposure to such assumptions.

<u>Communication and Collaboration</u>. The compensation committee needs to communicate and collaborate effectively with the chief executive officer. The compensation committee must also communicate regularly with other senior officers and managers (particularly those with human resources or risk management responsibilities) so that the flow of information between the committee and management is not impeded. Because of the complexity of compensation arrangements, committee members are expected to challenge management and the committee's external advisers on any compensation issue that they do not understand. The FCA also expects the compensation committee to provide prompt notice to FCA of any material changes in the institution's compensation program and to then disclose this information to the institution’s shareholders in a timely manner.

<u>Disclosures and Transparency</u>. Section 620.5(i) of FCA’s regulations details the compensation information that must be disclosed in the annual reports of System banks and associations.[4] FCA expects the compensation committee to review the compensation discussion and analysis to determine whether it meets the regulatory requirements of § 620.5(i) and whether the discussion is prominent, inclusive, and understandable. The board of directors and its compensation committee should not rely on the qualified public accountant for review of the

compensation disclosure because such a review is not generally within the scope of the audit of the financial statements. The critical question for the compensation committee is whether the committee's decisions with respect to compensation matters are sufficiently transparent so that the reader of the disclosure understands the institution's compensation philosophy and practices.

FCA Oversight. FCA will continue its oversight of the conduct and operation of System institutions' compensation committees and the process by which the institutions develop compensation disclosures for reporting purposes. FCA will also take appropriate steps to ensure that full disclosure of compensation programs occurs.

In conclusion, System shareholders and investors in System securities are watchful of how the boards of directors, through their compensation committees, are carrying out their fiduciary obligations, both individually, to their respective shareholders and, collectively, to their investment community. This is evidenced by the institutions' annual published disclosures on executive compensation and compensation programs and the Systemwide report to investors. As a collective of farmer-owned cooperatives, the System holds a unique and distinguished position in agricultural financing and plays an increasingly significant role in lending to agriculture and rural America. It is essential that the System remain safe, sound, and financially strong, so it is there for America's next generation of farmers, ranchers, cooperatives, and rural communities. To ensure this outcome, System institutions must remain accountable to their respective shareholders, maintain strong governance practices, and demonstrate financial prudence in their decisions, including those on executive compensation.

If you have any questions regarding this communication, please contact your institution's examiner in charge or you may contact Andrew D. Jacob, CFA, Director, or Gary Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, at (703) 883-4414, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov.

Copy to: Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

[1] Under section 514 of the Farm Credit Banks and Associations Safety and Soundness Act of 1992, Pub. L. 102-552,106 Stat. 4102 § 514 (1992), FCA must ensure that the financial disclosures (including disclosure of compensation) by System directors, officers, and employees provide (1) the institutions' shareholders with information they need to make informed decisions regarding System institutions' operations, and (2) investors with information they need to make decisions on purchasing System debt. FCA monitors, examines, and regulates the financial disclosures of all System institutions to ensure accurate reporting and disclosure occurs.

[2] Under § 620.31 of FCA's regulations, each bank and association board of directors must establish and maintain a compensation committee by adopting a written charter that describes the committee's composition, authorities, and responsibilities. Under § 630.6(b) of FCA's regulations, the Federal Farm Credit Banks Funding Corporation must also establish and maintain a compensation committee.

[3] Section 620.31(c) of FCA's regulations requires each bank and association to provide monetary and nonmonetary resources so the committee can function effectively. Section 630.6(b)(3) of FCA's regulations has a comparable requirement for the Federal Farm Credit Banks Funding Corporation.

[4] Associations have the option of disclosing this information in their Annual Meeting Information Statements.

BL-061
Rural Housing Mortgage-Backed Securities

November 12, 2009

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit System Banks

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Rural Housing Mortgage-Backed Securities

The Farm Credit Administration (FCA) authorizes Farm Credit System (System) banks to hold rural housing mortgage-backed securities (RHMS) as mission-related investments under § 615.5140(e) of FCA's regulations, subject to the conditions specified below.

System associations may originate rural home loans (RHLs) that meet certain criteria under § 613.3030 of FCA's regulations.[1] Under § 613.3030(d)(1), a System bank is authorized to purchase and hold RHLs in an amount not to exceed 15 percent of its total outstanding loans at any one time. Under existing authorities, a System bank may opt to hold the RHLs until maturity. In addition, if the RHLs qualify, a System bank has the authority to take one of three other actions with respect to the RHLs. First, the System bank can have its RHLs securitized into RHMS that are guaranteed by Farmer Mac for the purposes of managing credit and interest rate risk and furthering its mission of financing agriculture, up to 100 percent of its total outstanding loans, pursuant to § 615.5174.[2] Second, a System bank can have its RHLs securitized into RHMS that are guaranteed by Ginnie Mae,[3] Fannie Mae, or Freddie Mac as eligible investments pursuant to § 615.5140.[4] Third, the System bank can enter into a long-term standby commitment to purchase (standby agreement) with one of the government-sponsored enterprises (GSEs). Under a standby agreement, a System bank can opt to (1) sell the RHLs to the GSE for cash or (2) have its RHLs securitized into RHMS that are guaranteed by the GSE.

Under §§ 615.5132 and 615.5140(a)(5) of FCA's regulations, a System bank may hold any government- or GSE-guaranteed RHMS for the purpose of complying with its liquidity reserve requirement, managing surplus short-term funds, and managing interest rate risk. The FCA is issuing this bookletter to authorize System banks to also hold RHMS as mission-related investments under § 615.5140(e) for the purpose of addressing liquidity needs in the rural housing mortgage market, subject to the following conditions:[5]

1) RHMS must meet the definition of "mortgage securities" as defined in § 615.5131 of FCA's regulations.
2) The RHLs underlying RHMS must be eligible rural home loans originated by System associations under § 613.3030.

3) Investments in RHMS must be fully guaranteed by the United States (e.g., Ginnie Mae), Fannie Mae, or Freddie Mac with terms of no more than 30 years.
4) The aggregate amount of RHMS that a System bank can hold at any one time may not exceed 15 percent of the bank's total outstanding loans. All RHLs made by System associations that have been purchased by the System bank and remain on its books must also be included in this limit. This limit is independent of any current regulatory portfolio limitations for investments in mortgage securities under §§ 615.5132, 615.5140(a)(5), and 615.5174 of FCA's regulations, or other mission-related investment limit.
5) RHMS must be maintained in a portfolio separate from other investments so that they are readily identifiable.
6) RHMS must be prudently managed in accordance with the System bank's investment policies.
7) RHMS must be reported in accordance with generally accepted accounting principles.
8) RHMS must be excluded from the liquidity reserve requirement under § 615.5134 of FCA's regulations.

In implementing this authority to hold RHMS as mission-related investments, we expect each System bank to follow prudent risk management practices such as establishing appropriate board approved exposure limits to the housing GSEs and the housing sector. We also expect each System bank to monitor these exposures through its ongoing credit oversight program. If you have any questions regarding this bookletter, please contact Andrew D. Jacob, Director, Office of Regulatory Policy, at 703-883-4356 or via email at jacoba@fca.gov or Laurie Rea, Associate Director, Office of Regulatory Policy, at 703-883-4232 or via email at real@fca.gov.

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[1] Section 613.3030 implements the rural housing financing provisions at sections 1.11(b) and 2.4(b) of the Farm Credit Act of 1971, as amended.

[2] RHMS guaranteed by Farmer Mac are not within the scope of this bookletter.

[3] Ginnie Mae (Government National Mortgage Association) is a wholly owned U.S. government corporation.

[4] Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) are housing GSEs.

[5] All references to RHMS in these conditions refer to RMHS that are backed by rural home loans originated by System associations and are held as mission-related investments.

BL-062
Evaluating Strategies and Risks for Loan Pricing and Structure

May 13, 2010

To: Chairman, Board of Directors
Chief Executive Officer
Chairman, Asset/Liability Management Committee
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Evaluating Strategies and Risks for Loan Pricing and Structure

This bookletter provides guidance for the pricing and structure of loans to ensure appropriate earnings performance. Earnings performance is critical to the viability of a Farm Credit System (System) institution as it is the first line of defense against loan losses and the erosion of capital. Accordingly, investors in System debt and the rating agencies view System earnings and profitability as a major component of the System's financial stability. Conversely, declines in earnings performance can adversely impact the System's ratings and/or increase the cost of funding.

Background

The System generates the majority of its earnings from loans. Therefore, strategies for loans, including loan pricing, structure, funding, liquidity, and risk management, play a fundamental role in the earnings performance of a System institution. Appropriate loan pricing and structure decisions are particularly critical during volatile economic times, as recently experienced and likely to occur again in the future. Sufficient earnings help maintain the System's strong bond ratings and its reputation with investors, enable it to serve its mission, and ensure member owners benefit from their System cooperative.

Section 1.1(c) of the Farm Credit Act of 1971, as amended (Act), requires System institutions to provide equitable and competitive interest rates–taking into consideration a borrower's creditworthiness, access to alternative sources of credit, cost of funds, cost of servicing, and the need to retain earnings to protect borrowers' stock. Further, the Act states that in no case is any borrower to be charged a rate of interest that is below competitive market rates for similar loans made by private lenders to borrowers of equivalent creditworthiness and access to alternative credit. Therefore, properly pricing for risk in individual loans is critical to determining whether an institution is pricing loans consistent with rates available in the marketplace for loans that present similar risk characteristics.

Guidance

This bookletter communicates critical factors each System institution should consider when developing loan pricing and structure strategies. These strategic responsibilities reside with the board, but are typically administered by the institution's asset/liability management committee (ALCO). As discussed in FCA bookletter BL-012, dated January 15, 1991, all System institutions should have an asset/liability function administered by an ALCO as a critical component of its management system.

Due to the significant impact of loan pricing and structure on System institutions' earnings capacity, and to ensure consistency with the institutions' business plan goals in the current operating environment, System institutions' boards should continue to evaluate their direction and control over pricing and structure decisions. System institutions should manage loan pricing and structure using strategies that are well-developed, documented, and available for board and regulatory review. Boards of directors and senior management should review the institution's portfolio strategy periodically and should increase the frequency of review if the operating environment or portfolio mix warrants additional attention.

FCA regulations require System institutions to adopt written standards for prudent lending and written policies and procedures for prudent credit and loan pricing and structure practices. Specifically, when establishing and reviewing loan pricing and structure policies, procedures, standards, and practices, the FCA expects each System institution to:

1. Ensure loan pricing and structure decisions are consistent with the board's portfolio strategy and business plan objectives.
2. Incorporate appropriate risk based premiums into differential loan pricing programs.
3. Ensure the loan product mix provides sufficient flexibility to adjust rates/returns.
4. Evaluate how loan pricing and structure practices are affecting loan portfolio salability/liquidity.
5. Ensure pricing on all loan products/structures appropriately considers credit risk over the term of the loan, including the uncertainty of credit conditions in future periods.
6. Evaluate whether pricing practices provide sufficient margins for patronage and/or financial uncertainties of the institution.
7. Ensure loan pricing and structure practices meet statutory and regulatory objectives.

In addressing these areas, your institution's ALCO should, at a minimum, consider and address the questions discussed in the attachment. FCA examiners will use this guidance to aid in the evaluation and discussion of loan pricing and structure practices with System ALCOs, audit committees, boards, and management teams.

If you have questions in regard to this guidance, please contact Barry Mardock, Associate Director, Office of Regulatory Policy, at (703) 883-4456, or at mardockb@fca.gov, or Tim Nerdahl, Policy Analyst, Office of Examination, at (952) 854-7151, ext. 5035, or at nerdahlt@fca.gov.

Attachment

Attachment

1. How are loan pricing and structure used to achieve portfolio strategies and business plan objectives?

Each System institution should establish business plan goals and related portfolio strategies considering the board's risk appetite, its lending environment and the need to meet the System's long-term mission to serve agriculture. Loan pricing and structure are the critical tools for achieving these goals and strategies. A portfolio strategy assesses the current composition of an institution's portfolio, evaluates the loan products that are currently offered, and then provides the board and management's vision of what the portfolio composition should look like in the future. For example, a System institution may see opportunities to diversify the portfolio through syndications and loan participations or changing the duration of the portfolio from long-term loans to more short-term loans or vice versa. The FCA considers the review and assessment by a System institution of its portfolio strategy to be a prudent business practice and an integral part of its business and capital planning process. Conversely, operating without a portfolio strategy could result in excessive portfolio concentrations and insufficient earnings performance levels in future periods.

A portfolio strategy developed as part of the business planning process should cause a System institution's board and management to ask critical questions regarding the institution's expertise and capital adequacy. For example, System institutions involved, or planning to become more involved, in capital markets/participation activity should proceed in a thoughtful manner after fully considering the following questions: 1) How well do we understand loan pricing and structure in this marketplace? 2) Do we have a solid strategy and do we truly have the expertise and experience necessary to engage in this business activity and conduct our own due diligence in a prudent and sound manner? 3) Are the terms and returns available in the marketplace for these loans consistent with our risk management objectives? 4) How much capital will be needed to support the risk associated with moving into these new products or types of loans? 5) What type of risk-adjusted return do we need to adequately compensate our shareholders for the risk taken? By asking these types of questions, management and the board can provide a clear assessment of what it will take to enter different markets and whether this business will contribute to the institution's overall success.

2. Do your pricing programs provide for sufficient risk differential?

System institutions should be compensated for the risk they are taking. Different loans present different risks, depending on variables including loan type, purposes, terms, collateral risk, amount, quality, and financial stability of the borrower. As a result, higher interest rates should be established for loans that expose an institution to more risk. A borrower whose loan is appropriately risk rated a 4 or 5 should generally pay a lower rate of interest than a similarly situated borrower whose loan is risk rated an 8 or 9 for the same product (if financed at the same time). Likewise, borrowers whose loans pose higher loss expectation in the event of default should also pay a premium compared to borrowers whose loans pose a low loss expectation in the event of default.

Differential or tier-based pricing programs are designed to ensure interest rates charged to borrowers reflect the inherent risk in specific loans or loan types. As provided for in FCA regulation § 614.4160, differential loan pricing allows System institutions to reflect the variances in costs associated with various loan products while ensuring that equitable rate treatments are achieved within categories of borrowers. Interest rates may be differentiated by risk factors (e.g., classification/risk rating, loss given default rating, or performance status), loan characteristics (e.g., size, enterprise, servicing costs, collateral risk, or credit factors), loan terms, geographic area, or a combination of factors. Often, stress testing helps to differentiate the underlying risk exposure of a loan under various economic scenarios, which can serve to ensure an institution is appropriately pricing a loan consistent with risk it represents.

The establishment of interest rates requires analysis of risk in the loan portfolio to determine whether spreads remain adequate given the level of risk in the particular loan or group of loans. Controls should be in place to ensure that loans are assigned differential rates according to established procedures and are reviewed to ensure proper assignment and recording. While pricing exceptions can be granted for competitive reasons, System institutions should monitor the rate of exceptions to ensure the integrity of the pricing program and achievement of earnings objectives. Loans should be reviewed periodically, at renewal, or as repricing opportunities arise, to assess performance and adherence to program criteria. Failure to make necessary adjustments can result in insufficient returns relative to the changes in risk exposure.

System institutions should establish a means whereby differential loan pricing practices and risk-adjusted returns are monitored on an ongoing basis. This allows a System institution to make adjustments if the return on a specific loan product is inadequate in relation to the institution's business plan goals and/or risk assumed. Boards should also monitor this type of information to remain informed about the institution's loan pricing practices.

Risk-adjusted pricing models should be used in the pricing process. These models can vary from relatively simplistic to more sophisticated models, such as economic capital and risk-adjusted return on capital models. At a minimum, these models should consider the cost of funding, option risks that are not eliminated through funds transfer pricing, allocated operating costs, expected and unexpected loan losses, and profit objectives. These models could also consider other factors, such as loan structure and the effects of diversification or concentration. Any pricing model is highly dependent upon underlying assumptions and historical information. As a result, institutions should have processes for accumulating this information and validating assumptions. The complexity of validation processes should vary in accordance with the complexity of the pricing model.

3. Do your loan pricing and structure practices provide sufficient flexibility to maintain stable earnings and protect capital?

System institutions, from time to time, will need to adjust their interest rates to generate sufficient earnings to protect capital. Interest rates and spreads that appear sufficient during strong economic times may prove to be insufficient during economic downturns and/or times when funding markets are volatile or access is otherwise restricted. System institutions should have strategies in place to evaluate whether their loan pricing practices will continue to meet earnings objectives during periods when the funding environment becomes more volatile, market interest rates are changing rapidly, and credit risk is increasing. An institution's pricing program should ensure that loan spreads are adequate to cover risk (including future allowance needs) and funding costs, and provide a sufficient return to capital throughout the term of the loan, including during a volatile operating environment. Use of differential pricing programs, economic capital models, market studies, and other risk analysis tools can be useful for ensuring appropriate pricing relative to risk in individual loans. System institutions should use such tools to evaluate whether their loan pricing and structure practices provide sufficient flexibility to adjust spreads and interest rates charged to borrowers. It is critical that System institutions make the tough decision to increase and maintain spreads when adverse conditions are expected or become evident in the institution's operating environment.

Many System institutions offer administered-rate loans in part because these loan products provide flexibility to increase rates or increase spreads when needed. Contractually, administered rates can be changed periodically regardless of changes in market rates. In theory, administered-rate loans provide the flexibility to increase spreads at any given time with proper notification. However, in practice, administered-rates might not be changed in a manner fully responsive to changes in market rates or risk conditions in the environment. Administered-rate changes can be unresponsive to market rate changes if institution boards and management are hesitant to change rates given concerns over membership reaction. Failure to adjust administered-rate loans in concert with market rates may result in unintended consequences for a System institution, such as reduced spreads and earnings performance. Accordingly, System institutions should have significant discipline and internal controls over administered rates to ensure needed rate changes are made in a timely and appropriate manner.

If priced and funded properly, a loan portfolio that contains a large volume of fixed-rate and/or indexed-rate loans should, over time, produce a relatively stable stream of earnings. However, if these loans are aggressively priced with thin spreads, they may produce, over time, a loan portfolio with insufficient margins to generate the earnings necessary to provide for loan losses and protect capital. System institutions with large concentrations in fixed-rate and indexed-rate loans can only adjust spreads by increasing rates on new loans and existing administered-rate loans, taking these institutions much longer to increase their overall portfolio profitability. In addition, System associations' transfer pricing programs with their funding banks may allow the bank to change spreads charged to its associations at any time. Consequently, spreads may compress on existing loans in the portfolio. Accordingly, an association's portfolio mix and pricing strategies should provide sufficient flexibility to ensure that the loan portfolio continues to provide sufficient returns under varying conditions.

4. How do your loan pricing and structure practices impact the liquidity of your loan portfolio?

To fully understand the impact of its loan pricing and structure decisions, System institutions should consider how their loan products would sell in the financial marketplace. While System institutions generally hold loans they originate, and the secondary market for agricultural loans remains a limited source of liquidity, institutions are encouraged to evaluate the market value of their loans. We recognize there are unique features to System loans that could impact their value and salability; however, we believe it is important for System institutions to determine the market value of their loan portfolios as a tool to measure how liquidity and capital strength are impacted by loan pricing and structure decisions. The various structures, lack of standardized market terms and covenants, and optionalities of the products offered can greatly impact a loan's salability and value in the marketplace. Loans that are structured in a way that could reduce salability should not have liquidity impacted further by insufficient pricing.

One way System institutions could evaluate portfolio salability is to periodically complete an analysis of the liquidity and market value of their loan portfolio. This analysis could include data supporting the marketability of the loan portfolio and expected market price that could be achieved. This analysis would keep management teams and boards informed on decisions resulting from their loan offerings and how these decisions have impacted earnings and liquidity of their institution. This information would then allow management to make adjustments needed to meet earnings and liquidity objectives.

5. When evaluating the risks associated with long-term loans, how do you ensure that they are appropriately priced and provide adequate compensation for the risks assumed?

Long-term loans pose unique risks that System institutions need to fully consider in pricing decisions. System institutions that index or lock in borrower interest rates for long periods of time may be protecting the borrower from rising interest rates, but may be under-pricing for the uncertain credit risk in future periods. Consequently, System institutions should ensure that interest rate spreads on long-term fixed-rate loans are sufficient to compensate for the additional risk being assumed over the life of the loan.

Risk in long-term loans emanates from the uncertainty of future economic events. In addition, institutions often find it difficult to obtain current information on the borrower's financial condition and performance and are typically unable to adjust loan pricing based on changes in the borrower's risk profile. Without updated financial information it is difficult to identify deterioration in credits prior to a customer missing a payment. To address this risk, many institutions make loans with 15- or 20-year amortizations with balloon payments due in 5 to 7 years. The balloon maturity provides an opportunity to revisit the borrower's risk profile. Loan documents, at a minimum, should be designed to obtain updated financial information when needed. Accordingly, System institutions should ensure that proper controls and/or pricing for long-term fixed-rate loans mitigate and/or compensate the institution for assuming this risk.

6. How do your patronage practices enter into loan pricing and structure decisions?

System institutions with sufficient earnings may reflect those earnings in making patronage payments to their customers or in offering more advantageous loan terms to their customers. Charging customers a rate up front that supports plans to pay patronage later can help ensure that System institutions have an earnings buffer in the event provisions for loan losses, in excess of business planning projections, become necessary. This additional flexibility and buffer for an institution is also recognized by investors in System debt securities. Investors tend to focus on the System's pre-patronage return on assets and equity, recognizing that institutions can lessen or defer patronage payments based on the needs of the institution. Nevertheless, System institutions that have a history of paying patronage refunds and then stop or lessen payments can experience borrower discontent as members come to expect patronage refund checks. Accordingly, System institutions should ensure that member/borrowers are fully informed that as a cooperative, the capital needs of the institution may take priority over the patronage needs of the membership during periods of economic stress.

Some System institutions offer more advantageous loan terms to their customers to compensate for not paying patronage. However, charging lower rates and achieving lower spreads on loan products may not provide for the additional earnings necessary for financial uncertainty. Financial uncertainty would include unplanned provisions for loan losses, capital erosion, and other unforeseen expenditures. In these cases, compensating strengths should be in place to mitigate financial uncertainty. Compensating strengths could include higher capital levels, a low operating expense rate, or the use of conservative underwriting standards and lending limits. Consequently, pricing programs that do not take into consideration the potential for financial uncertainty or possess compensating strengths can be considered unsafe and unsound.

7. How do your loan pricing and loan structure practices help meet your institution's statutory and regulatory service objectives?

An institution's portfolio strategy must provide for an adequate and flexible flow of funds into rural areas and provide competitive credit for farmers and ranchers. Chosen strategies must also accommodate the furtherance of statutory and regulatory service objectives. For instance, FCA regulation § 614.4165 requires System institutions to establish programs to provide sound and constructive credit and services to young, beginning, and small (YBS) farmers, ranchers, and producers or harvesters of aquatic products. As further discussed in FCA bookletter BL–040 Revised, such programs could include applying more flexible interest rates or fees, customized loan underwriting standards, loan guarantee programs or other credit enhancement programs. In addition, FCA regulation § 614.4160 states in the adoption of differential interest rate programs, institutions may consider, among other things, the effect that such interest rate structures will have on the achievement of objectives relating to the special credit needs of YBS farmers.

A sound portfolio strategy provides System institutions with the foundation to ensure that sufficient earnings and capital are in place to fully implement the System’s statutory and regulatory service objectives. A critical component of that strategy is to have in place pricing and structure practices that ensure that credit is available, where and when it is needed most. Therefore, the critical factors discussed above must be considered in the context of the System’s overall mission to provide sound and dependable credit to agriculture and rural America.

BL-063
Farm Credit System Bank Merger Applications

July 8, 2010

To: Chairman, Board of Directors
Each Farm Credit System Institution

Chief Executive Officer
Each Farm Credit System Institution

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Farm Credit System Bank Merger Applications

This bookletter has been approved by the Farm Credit Administration (FCA or Agency) Board and communicates the Agency's expectations for the submission of proposals to merge Farm Credit System (FCS or System) banks.[1] The FCA Board recognizes that merger decisions primarily rest with System stockholders. However, given the complexity of issues that may result from bank mergers, the FCA Board also wants to ensure that merger applications identify and comprehensively address all the broad implications for the System and its institutions.

Mergers of FCS banks[2] may provide benefits and create risks for the merging banks, bank shareholders, the System as a whole and all eligible borrowers. Benefits of a bank merger may include portfolio and geographic diversification, improved risk-bearing capacity, management capability, and operational efficiencies. However, a bank merger may increase risk by creating a larger, more complex and difficult-to-manage institution. Such a bank may present broad risks to other System institutions. As discussed more fully below, when evaluating a bank merger application, the FCA will carefully consider the long-term impact on the safety and soundness at the institution, district, and System levels, including size concentration risk, business model compatibility, and intra-System operational risk. Of particular importance are the implications these risks may have on the System's long-term service to eligible borrowers and its continued ability to fulfill its mission as a government-sponsored enterprise (GSE). Therefore, the FCA expects bank merger applications to clearly and fully address:

- The risks that the larger bank would create for the continuing bank's shareholders and System as a whole, including the impact on the System's repayment of joint and several debt obligations and protections available to investors in System debt.

- How the resulting bank and the System would be structurally safe and sound for the long-term, including the long-term compatibility of the shareholder associations with the business philosophy of the bank.

- How the proposed merger furthers intra-System collaboration and coordination on intra-System operations, furthers the System's GSE mission, including service to eligible borrowers, and safeguards the American taxpayer in the financial performance and mission service of the System as a GSE.

Size Concentration Risk

During the 1980s and 1990s, with dramatic changes in the financial landscape, the System evaluated and implemented various alternative organizational structures to better position System institutions for providing financial products and services to agriculture. The various mergers, territorial realignments, transfers of direct lending authorities, and other organizational changes have resulted in a complex array of differently sized entities, overlapping territories and different business models. At the bank level alone, the number of institutions went from 37 in 1988 to 5 today, with 2 bank districts accounting for over 62 percent of total System assets. Future bank mergers would further concentrate System assets.

Size concentration risk is a significant safety and soundness issue that must be addressed in any bank merger application. The bank merger application must include an analysis of the size concentration risk being borne by the other banks, the System as a whole, and by investors in Systemwide debt obligations. For instance, concentrating assets and funding in a single bank's business model may unduly stress the Insurance Fund and the statutory joint and several liability of the remaining banks. To address size concentration risk, merger applications must identify needed risk mitigating controls such as stronger financial performance requirements, enhanced standards and obligations in intra-System agreements and, possibly, equalization through association re-affiliations, territorial adjustments, or other structural or financial approaches that could occur contemporaneous with the merger. As part of the analysis of size concentration risk, it is important that the merging banks consult with other banks on appropriate and acceptable risk mitigating actions and controls.

Business Model Compatibility

Bank mergers succeed or struggle based on the level of business model, cooperative philosophy, and operating practice compatibilities between the bank and its shareholder associations. Therefore, it is important for a bank and its affiliated associations to share business model compatibility in order to achieve long-term success. This compatibility is essential whether the bank is a limited-service, full-service, or mixed retail-wholesale bank. Successful integration into a cohesive bank district requires the long-term support of the resulting bank's affiliated associations and their respective boards and management teams. Given the risks posed by business model incompatibilities to the long-term financial and operating success of a bank, merger applications must identify and analyze the risks and provide practical approaches for addressing them. These approaches may include providing associations that have different philosophies the opportunity to re-affiliate contemporaneous with the merger. Alternatively, the bank may consider refining its business practices or governance structure to result in greater compatibility with the district business model, cooperative philosophy, and operating practices.

Intra-System Operational Risk

Associations' ability to serve eligible borrowers depends on the System's collaboration and coordination on various intra-System operational matters. For instance, associations rely, to varying degrees, on their funding bank, including bank support for needed loan products and related services, skill in obtaining cost-efficient funding, ability to limit interest-rate risk, and success in managing liquidity risk. Similarly, all banks work together to access the financial markets, coordinate on loan products and services, and on other matters.

A bank merger may concentrate significant influence, management decision making, and authority in the resulting bank. Therefore, bank merger applications must include: (1) an assessment of the impact that the merger will have on representation in various Systemwide decision-making and coordination bodies; and (2) identify any needed enhancements or new measures that ensure long-term cooperation across the System. Within the bounds of safety and soundness, the FCA wants to ensure that coordination and cooperation across the System continues to facilitate individual institutions fulfilling and furthering their statutory mission as GSEs. The FCA expects the merging banks to use a cooperative and collegial approach in addressing this issue by communicating with their respective shareholders and all System banks and associations in the process.

Conclusion

Open communication with the merging banks' respective shareholders and comprehensive disclosure are essential to fully identify and address these broad issues. Similarly, discussion and coordination with other System banks and their shareholders will be important in analyzing and addressing potential issues that may impact the System. FCA expects early and ongoing communication when banks are considering a possible merger, including an early review of the many potential agreements or arrangements needed to facilitate the process.

As we have done for association merger applications, the FCA intends to issue bank merger guidelines that describe the bank merger application process and list the specific information and documents that a bank merger application must contain. These bank merger guidelines well help facilitate comprehensive and complete bank merger applications.

Please contact Thomas L. Dalton, Associate Director, at (703) 883-4460 or daltont@fca.gov or Andrew D. Jacob, Director of the Office of Regulatory Policy, at (703) 883-4356 or jacoba@fca.gov, if you have any question regarding this bookletter.

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[1] Section 611.1020 of FCA's regulations states:

> Where two or more banks plan to merge or consolidate, the banks shall jointly submit to the Farm Credit Administration the documents itemized in §§ 611.1122(a)(1) through (4), (6), (7), 611.1122(e) and 611.1123. In interpreting those sections, the word "bank" shall be read for the word "association."

Section 611.1122(a)(7) requires that banks include in their merger applications any information or documents requested by the FCA in addition to the documents and information specified in the regulations.

[2] Subject to the FCA's approval, FCS bank mergers are authorized under sections 7.0 and 7.12 of the Farm Credit Act of 1971, as amended (Act).

BL-064
Farm Credit System Investment Asset Management

December 9, 2010

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Farm Credit System Investment Asset Management

This bookletter has been approved by the Farm Credit Administration (FCA, we, our) Board. It applies to all Farm Credit System (System or FCS) banks or associations (institutions) that hold eligible investments for the purposes set forth in §§ 615.5132 and 615.5142 of FCA regulations.[1] It is intended to provide clarification and guidance regarding FCA's regulations and expectations with respect to the key elements of a robust investment asset management framework that each institution should establish to prudently manage its investments in changing markets.

Under § 615.5132, System banks may hold eligible investments for the purposes of maintaining a liquidity reserve, managing surplus short-term funds, and managing interest rate risk. Under § 615.5142, Farm Credit associations may hold eligible investments to reduce interest rate risk and to manage surplus short-term funds, subject to the approval of their funding banks. These purposes do not authorize System institutions to accumulate large investment portfolios for arbitrage or trading activities.

Section 615.5140(a) provides a list of eligible investments.[2] The regulation specifies appropriate asset classes, maturity limits, portfolio limits, obligor limits, and other requirements. Section 615.5140(c) requires that all eligible investments, except money market investments, must be marketable, stating that an eligible investment is marketable "if you can sell it quickly at a price that closely reflects its fair value in an active and universally recognized secondary market."

Section 615.5133 of our regulations establishes requirements for implementing an effective oversight and risk management process for investment activities and liquidity management.[3] Strong investment asset management begins with appropriate board and senior management oversight. The board of directors is responsible for establishing written investment policies that are appropriate for the size, types, and risk characteristics of its institution's investments. Investment policies are a critical aspect of effective risk management and should set appropriate limits on exposure to credit, market, concentration, and liquidity risks. Senior management is responsible for implementing board direction and ensuring that it is carried out.

During the prolonged period of financial stability that preceded the recent financial crisis, FCS institutions' investment management policies and allocation strategies were adjusted infrequently and investments were seldom subject to credit risk stress tests. Although the System has experienced considerably less investment stress during the crisis than many other financial institutions, both FCA and the System recognize that more frequent adjustments to investment management policies and allocation strategies and more frequent credit risk stress tests would have improved institutions' investment management processes and could have resulted in a higher quality, more liquid portfolio during the crisis. Accordingly, FCA expects, even during periods of stability, that each System institution will revisit its investment allocation strategies frequently (more than once a year), in order to manage asset concentrations that could increase its liquidity risk and impede its ability to convert investment positions to cash quickly, if needed. In addition, each institution should ensure it has the appropriate tools in place to evaluate credit risk during the purchasing process and on an ongoing basis.

Further, some System institutions invested in structured products, including private placements, in volumes representing high concentrations of capital. During the financial crisis, many of these securities became distressed and illiquid. As a result, these institutions experienced a significant deterioration in investment asset performance and quality which increased their liquidity risk profile during a period when market access was tenuous and stressed. In light of this experience, FCA expects an institution to use prudent investment asset management to ensure that the institution maintains a pool of highly liquid assets. In particular, the FCA expects the board and senior management of each institution to:

- Establish prudent policies, procedures, and internal controls to effectively oversee the institution's investment activities, including establishing appropriate delegations of authority, purchase and hold limits, segregation of duties, and reporting;

- Limit concentrations of risk in particular counterparties, asset classes, individual securities or tranches, sectors, and industries;

- Develop an appropriate independent credit analysis process that has reduced reliance on Nationally Recognized Statistical Rating Organization (NRSRO) credit ratings and that includes an evaluation of the underlying cash flows, price risk, and collateral under stressed conditions; and

- Ensure that all investments purchased meet FCA's regulatory definition of a "marketable" investment and that the institution establishes procedures and processes to evaluate the marketability and liquidity of the investment portfolio.

FCA examiners will use the guidance set forth in this bookletter in evaluating investment asset management practices and in discussing those practices with System asset liability management committees (ALCOs), audit committees, boards, and management teams.

The recent financial crisis and its lingering effects have re-emphasized the importance of sound investment and liquidity risk management practices by System institutions. Sufficient oversight by each System institution's board of directors and senior management is a critical control for prudent investment asset management. We recognize that the System banks have added high quality liquid assets to their investment portfolios to help ensure sufficient liquidity going forward. Institutions should expect FCA examiners to continue to closely evaluate risk management policies and procedures as well as investment portfolio composition, performance, and risks. In addition, the FCA Board plans to consider regulatory changes relating to eligible investment assets to ensure that prudent practices are in place for the safe and sound management of investment portfolios.[4]

If you have questions in regard to this guidance, please contact Laurie Rea, CFA, Associate Director, Office of Regulatory Policy, at (703) 883-4232, or at real@fca.gov, or Tim Nerdahl, Senior Financial Analyst, Office of Regulatory Policy, at (952) 854-7151, ext. 5035, or at nerdahlt@fca.gov.

Attachment

Attachment

Investment Asset Management

The topics discussed in this attachment address critical components of investment asset management. System institutions should address these items in their investment policies and practices to ensure adequate controls and governance are in place to manage risk, while achieving liquidity objectives and maintaining safety and soundness.

Effective investment asset management is founded on three fundamental pillars: Board and senior management oversight, risk management and measurement, and risk evaluation. The basic tenets of these pillars and FCA expectations are outlined and discussed below.

Pillar 1: Board and Senior Management Oversight

- Investment policies
- Board involvement
- Investment plan implementation
- Reporting to the board

Pillar 2: Risk Management and Measurement

- Effective internal controls environment
- Independent audit program
- Due diligence and modeling cash flows and assumptions
- Credit risk evaluation
- Pricing and valuation practices
- Evaluation of liquidity and market risk
- Enterprise risk management

Pillar 3: Risk Evaluation

- Assessment of current economic and financial conditions
- Identification of emerging risks
- Sector risk evaluation
- Stress testing

This attachment concludes by discussing the regulatory requirements for associations that engage in investment activities.

PILLAR 1 – BOARD AND SENIOR MANAGEMENT OVERSIGHT

Satisfactory investment asset management begins with board and senior management oversight of the investment activities of an institution. The board sets the direction for the institution through investment policies and the planning process. Senior management implements board direction and reports to the board in accordance with FCA regulations and board policy.

Investment Policies: Section 615.5133(a) of FCA regulations requires the board of each System institution to adopt written policies for managing its investment activities. The policies must address the purposes and objectives of investments, risk tolerance, delegations of authority, and reporting requirements.[5] In addressing risk tolerance, the policies must establish risk limits and diversification requirements for the various classes of eligible investments and for the entire investment portfolio.[6] Asset allocation and diversification strategies are important elements of prudent investment portfolio management. Investment policies should identify specific risk limits, as well as liquidity and diversification requirements that are consistent with the objectives, capital position, and risk tolerance of the institution.[7] The policies should specify the types and amount of investments in which the institution may invest, taking into account the eligible investments and regulatory maximums specified in § 615.5140.[8] The policy should also clearly identify the responsibilities and limits of committees that oversee investments.

In general, policies should incorporate the following principal elements:

- Purpose of the policy and objectives that are to be accomplished;
- Parameters within which management and staff are expected to operate;
- Authorities delegated to management and authorities retained for board approval or action;
- Process for addressing exceptions; and
- Reporting requirements.[9]

Furthermore, an institution's investment policies must be appropriate for the size, types, and risk characteristics of the institution's investments.[10] At a minimum, the board of directors must review these investment policies at least annually and make any changes that are needed.[11] The board must ensure that management complies with its investment policies and that appropriate internal controls are in place to prevent loss.[12]

Board Involvement: Board members are expected to take an active role in risk governance, including having an effective internal controls environment and ensuring that the institution complies with applicable laws and regulations. Among the effective ways for the board to exercise risk governance over the investment portfolio is through the annual planning process.[13] Through the planning process, the board should establish the institution's strategic investment direction and provide guidance to senior management on implementation of its approved investment policies and strategies. The board should approve business plan goals based on its objectives and the ongoing operational and liquidity needs of the institution. The board should also evaluate the institution's existing portfolio during the planning process, including the risk and returns generated by the portfolio. In addition, the planning process should provide direction as to the targeted composition of the portfolio, based on the institution's liquidity and operational needs, and risk tolerance.

Investment Plan Implementation: Once an institution's board provides investment direction through its planning process, management must develop approaches to implement this direction. FCA regulations do not prescribe specific implementation approaches. However, sound business practices include the development of a dynamic investment plan and the establishment of a formal investment committee.

An institution's senior management should develop a sufficiently detailed investment plan to appropriately execute the board's approved investment strategies and achieve business plan goals of the institution. The plan should be approved by senior management, or at a high level of management such as the ALCO or other appropriate management committees. The investment plan should help provide for effective guidelines and control over the investment portfolio. The plan could take many different forms, but it should be a dynamic working document that can deal with changes in market conditions. The plan should identify the current implementation strategies necessary to deal with changes in the investment portfolio that might be needed to address ongoing liquidity requirements and asset liability management objectives. This would require the investment management staff to document the current focus of the investment portfolio, noting changes from the previous reporting period. In addition, the plan should identify, among other items, the projected sources of incremental returns, sectors or security types in which the institution expects to invest, investment class and security hold limits, and counterparty concentration limits.

Key elements of an investment plan include the following:

- An appropriate target portfolio composition given the investment policy parameters, current market conditions, and liquidity needs;
- Rebalancing tactics to achieve the target portfolio allocation from the current allocation; and
- Performance measures including target portfolio spread given the target portfolio composition and anticipated various spreads in relation to the institution's cost of funds.

To effectively implement the investment plan, each institution should consider establishing a formal investment committee to provide additional expertise and serve as an additional control over investment asset management. In the past, the ALCOs, which oversee the management of investment portfolios in most System institutions, have generally provided sufficient oversight of these portfolios. However, while not required by FCA regulation, the importance, volume, and growing complexity of System investments may warrant additional expertise in the form of an investment committee. The committee should be involved with tactical investment decisions and overseeing the risks in investments. Moreover, the committee should ensure that the institution's credit department oversees and analyzes complex credit assets that are structured as investments. In addition to providing additional expertise, the investment committee would also provide for separation of duties between allocation and risk strategies and the actual traders. This committee would also provide appropriate monitoring and governance as well as provide structure or formalization of many of the informal processes.

An effective investment plan and an engaged investment committee provides the ALCO and the board with a better understanding of the institution's approach to current and future investment activities.

Reporting to the Board: Each quarter, management must report to its board (or committee thereof) on the performance and risk of each class of investments and the entire investment portfolio.[14] Furthermore, reporting must reflect significant events affecting the institution's investment environment.[15] In addition, reporting must address whether investments are achieving their objectives.[16] For example, if a class of investments was purchased for the objective of maintaining a liquidity reserve, then reporting must address liquidity characteristics of the investment class and the extent to which the investments contribute to meeting the liquidity objective. The board should also require periodic review and reporting through the internal audit program. Timely and quality reporting on investment activities is an important component of board and senior management oversight. Institutions that conduct investment activity should ensure that the nature and frequency of the reporting is appropriate for risk in the portfolio and the current environment.

PILLAR 2 – RISK MANAGEMENT AND MEASUREMENT

This section clarifies our expectations for how a System institution can strengthen its risk management and measurement practices. Managing and measuring the risk in investments are critical parts of effective investment asset management. Strengthening these practices should improve the institution's overall management with respect to its investment portfolio. This section discusses an effective internal controls environment and the role of audit. In addition, this section discusses due diligence and the modeling of cash flows and assumptions, credit risk evaluation, pricing and valuation practices, and the evaluation of liquidity and market risk. Furthermore, this section discusses effective enterprise risk management practices that institutions need to recognize if they follow the prudent practice of managing risk from a global perspective.

Effective Internal Controls Environment: The board must ensure sound systems and controls are in place to manage investment risks.[17] Senior management is responsible for implementing an effective controls environment to manage risk in an institution's investment portfolio, as well as to ensure compliance with applicable laws and regulations. Diversification and providing for appropriate hold limits to ensure regulatory and board policy compliance are key controls. In addition, controls must be in place to ensure that only permissible investment activities take place.

Concentration in certain asset classes and securities highlighted control failures in many financial institutions during the height of the financial crisis. Careful investment selection and appropriate diversification are key ways to manage and control concentration risk. System institutions should effectively manage concentrations in any one investment issue or investment asset class, especially more complex, potentially illiquid, and higher-risk investments such as structured credit products. FCS institutions should limit their portfolio allocation in the following types of securities and, consistent with § 615.5140(c), must be able to demonstrate their marketability:

- Investments with historically volatile market values or cash flows;
- Structured investments with underlying collateral comprised of higher-risk assets or those likely to have limited liquidity in a stress environment;
- Investments that do not have readily determinable market values (that is, where price estimates rely on models instead of actual trades, such as investments classified as level 3 under Statement of Financial Accounting Standards 157/Accounting Standards Codification 820); and
- Investments that rely on a common risk mitigant, such as bond insurance.[18]

Each institution should review its risk profile on a routine basis and establish portfolio limits that are not only within the regulatory framework but are also within its risk tolerance limits and investment objectives. FCS institutions should limit their exposure to subordinated or complex structure investments that are otherwise eligible within a particular asset class and establish hold limits (or sub-portfolio limits) well below the regulatory maximums. For example, asset- and mortgage-backed securities often have multiple tranches of senior and subordinated securities that are all highly rated. FCS institutions should ensure the securities that they are purchasing meet their cash flow and risk and return objectives. Furthermore, while a class of investments may be eligible, buying entire tranches of a security generally does not provide System institutions with the necessary portfolio diversification and may also hinder future liquidity needs.

FCA expects FCS institutions to have sufficient controls to monitor investment trades to ensure their appropriateness and compliance with FCA regulations. Each institution must ensure it establishes the necessary controls to limit investment activity to permissible regulatory purposes. Specifically, FCS banks and associations are not authorized to engage in trading for speculative or primarily capital gains purposes. Realizing gains on sales before investments mature is not a regulatory violation as long as the profits are incidental to the permissible investment purposes outlined in § 615.5132.

Independent Audit Program: As discussed above, § 618.8430 requires each institution's board to adopt an internal control policy. System institutions should establish internal controls to ensure that an independent review over investment practices and controls is conducted. An institution's audit plan should include a risk assessment of the investment function by the internal audit department or by an outside vendor if the expertise in-house does not exist. The frequency and scope of review should be based on the complexity and size of the investment portfolio. For example, banks and associations with significant investment activities should typically ensure the investment function is audited at least annually. In addition, auditors should be rotated to obtain alternate views of investment operations. Outside audits of the portfolio should be conducted periodically as necessary to ensure an objective evaluation of practices and controls by qualified auditors.

Examples of areas that should be addressed by an institution's internal audit include, but are not limited to:

- Investment selection process;
- Process used by management to monitor investments;
- Incentives for traders and other treasury staff members/management;
- Risk management and measurement;
- Effectiveness of management oversight committees;
- Liquidity objectives;
- Portfolio composition;
- Reporting;
- Operational risk, including separation of duties, delegated authorities, and internal controls;
- Compliance with regulations, board policy, and procedures; and
- Implementation of FCA guidance (such as bookletters).

Due Diligence and Modeling Cash Flows and Assumptions: System institutions must conduct due diligence prior to purchasing a security. The degree of due diligence that an institution conducts must be commensurate with the complexity of the security. The need to evaluate and make a decision on a transaction quickly does not obviate the due diligence requirement. However, an institution may be able to conduct its analysis more efficiently by using a template or standardized form to document the risk and rewards of purchasing a particular security. Risk factors that must be considered in a due diligence analysis include, but are not limited to, price risk due to changing interest rates or prepayment speeds, and potential for credit risk deterioration and reduced liquidity and marketability under stressed conditions.

FCA expects that institutions thoroughly understand the risks and cash flow characteristics of their investments, particularly for products that have unusual, leveraged, or highly variable cash flows. System institutions must identify and measure risks prior to acquisition and periodically after purchase. It may be necessary to use third-party analyses that are independent of the seller or counterparty. In general, institutions should conduct and document due diligence analyses separately for each structured investment security. Modeling cash flows and assumptions at the time of purchase and periodically after purchase provides insight to the changing risks certain investments present.

Credit Risk Evaluation: Overreliance on NRSRO credit ratings in the credit evaluation of suitable investments was a significant problem for many financial institutions leading into the financial crisis. One reason that credit ratings may not necessarily reflect credit risk accurately is that the NRSROs and others may underestimate difficult-to-measure risk factors such as correlation. Correlation risk is the likelihood of an event that causes default of one credit increasing the likelihood of default in another credit.[19] In section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Reform Act), enacted on July 21, 2010, Congress recognized that credit ratings may not be the most appropriate means of determining creditworthiness.[20] Accordingly, institutions that continue to consider credit ratings as a factor in their pre-purchase and periodic investment credit evaluation should understand the processes and methodologies the NRSROs use as well as the limitations associated with these metrics.[21]

Moreover, we expect FCS institutions to reduce their reliance on credit ratings and to consider other factors in evaluating the risk present in credit products. A variety of robust pricing and valuation models include a credit assessment component. In particular, we encourage System institutions to use methodologies that incorporate the stress testing of cash flows, collateral default, and prepayment assumptions. Credit risk stress testing is a means to better understand the overall risk in the portfolio. Conducting such analysis would allow for better understanding of how certain investments fit in the overall risk framework of the institution.

Pricing and Valuation Practices: Section 615.5133(f) requires that before a System institution purchases a security, the institution must evaluate the security's credit quality and its price sensitivity to changes in market interest rates. The institution must also verify the value of a security that it plans to purchase, other than a new issue, with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction. Furthermore, the institution must determine the fair market value of each security in its portfolio and the fair market value of its entire investment portfolio at least monthly. The institution must also evaluate the credit quality and price sensitivity to change in market interest rates of all investments that it holds on an ongoing basis. Finally, before an institution sells a security, the institution must verify its value with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction.[22]

To satisfy these requirements, System institutions should have rigorous pricing and valuation practices in place to value investments. This includes using more than just dealer quotes but also using pricing services or other means of obtaining values. Achieving more than one price for each security provides for the ability to compare valuations.

Models may be used for securities that are more difficult to value. These models should have their assumptions calibrated regularly to ensure they are providing realistic valuations based on current market conditions. Model validation should be conducted regularly to ensure results are as accurate as possible. In addition, System institutions with securities that require models to assess their valuation should also ensure that these securities are marketable, which is a requirement for eligibility of all securities except money market instruments.[23]

Evaluation of Liquidity and Market Risk: Section 615.5132 of FCA regulations permits System banks to hold investments for liquidity reserve purposes. Investment policies must describe the liquidity characteristics of eligible investments that institutions will hold to meet ongoing liquidity needs, institutional objectives, and minimum regulatory liquidity requirements as described in §§ 615.5133 and 615.5134. As a result of the market turmoil, the quality and available liquidity of the investments of many System institutions have been adversely impacted, and the System, as well as FCA, recognize that liquidity, and liquidity policies, need to be strengthened. System institutions have already implemented action steps to improve liquidity, including holding larger quantities of higher quality liquid investments such as United States Treasury securities and other obligations that are fully guaranteed by the full faith and credit of the United States. We are currently reviewing our regulations and plan to propose enhancements in the future to help strengthen System liquidity.

A key component of liquidity, as well as a key component of investment eligibility under our regulations, is marketability.[24] Investments purchased for the purpose of meeting liquidity reserve objectives must be suitable for a liquidity portfolio, with broad market acceptance and limited risks. Even if investments are highly marketable when purchased, they may become less marketable or unmarketable in the future. In particular, even if private placements are eligible from a credit risk perspective at the time of purchase, experience has shown that they may not comply with FCA marketability requirements as discussed in § 615.5140(c). Liquidity for these investments may evaporate quickly in changing markets. Therefore, FCA expects FCS institutions to assess and test the marketability of their portfolio frequently, especially in areas where they have concentrations of asset classes. This assessment should include studies to determine the depth, breadth, and liquidity of the market for similar class and structure of securities.

Enterprise Risk Management: Some institutions have begun to move to a global, enterprise approach to assessing and managing risk. Enterprise risk management (ERM) identifies the broad spectrum of risks facing the institution, assesses the likelihood and magnitude of each risk along with risk correlations, and develops strategies for managing risks. ERM functions are a prudent business practice and provide a more disciplined approach to risk identification and management. Institutions that implement ERM functions should ensure risks from investment operations are considered and that those responsible for ERM have the tools and expertise to fully understand risks in investments and how it impacts the overall risk profile of the institution.

PILLAR 3 – RISK EVALUATION

An evaluation of risk is a crucial and ongoing component of investment asset management. Assessing current economic and financial conditions, emerging risks, and sector risk is critical to understanding the risk present in, and the impact various sectors have on, an institution's investments. Each System institution should continually monitor and assess risk so that the institution is aware of the external circumstances that can impact its investments and consequently its liquidity. This section also clarifies our expectations for stress testing mortgage-backed securities.

Assessment of Current Economic and Financial Conditions: Effective risk evaluation begins with an assessment of the current economic and financial conditions present in the marketplace. For instance, as we noted earlier, the financial crisis that began in 2007 did not deter institutions from purchasing higher risk mortgage-backed securities. At times, market conditions may change quickly and System institutions should have the ability, on an ongoing basis, to assess economic and financial conditions as part of their risk evaluation efforts and to adjust their portfolio strategies accordingly.

Identification of Emerging Risks: Emerging risks present additional challenges that System institutions should identify in their overall investment portfolio monitoring practices. Emerging risks, if identified early, can allow System institutions to exit certain segments of the portfolio or at least mitigate future risk of loss. Conditions may change very quickly and System institutions should have robust and dynamic monitoring systems and tools in place to ensure that emerging risks are identified and the effects of such risk on the institution are analyzed and understood. In doing so, System institutions can control and/or mitigate portfolio losses.

In evaluating emerging risks, institutions should ensure they consider:

- Correlation risk, changes in probability of loss, and loss given default;
- Ratings volatility risk (the potential for downgrade);
- Market liquidity and price discovery; and
- Credit spreads and volatility.[25]

In addition, System institutions with investments in private label structured credit products should take further steps to effectively monitor these types of investments. Specifically, institutions should track credit risk at the underlying collateral level, across securitization exposures, and within and across business lines. Also, they should obtain reliable measures of aggregate risk. This would include monitoring loan level risk limits where appropriate and restricting investment in securities backed by collateral with certain higher-risk characteristics. Higher risk characteristics would include higher loan-to-value ratios, low FICO scores, high delinquency rates, or securities that contain high levels of loans that were previously delinquent. Management should also consider other risks in such indirect investments, such as liquidity risk, especially in volatile markets.[26] Institutions lacking the expertise to fully understand the risks in these and other types of securities should not purchase them.

Sector Risk Evaluation: Being capable of understanding and evaluating the various sectors in which a System institution invests is critical to the institution's risk management and its overall management of its investment portfolio. Specific sectors include, but are not limited to, housing, automobiles, credit cards, and home equity type securities, as well as government guarantees. Having the appropriate tools and expertise to evaluate various sectors enables institutions to better understand the changing risks and complexities the investments pose. It is also critical that System institutions fully understand the impact that one sector may have on another.

Government-guaranteed investments are an important segment in the investment portfolio of many System institutions. As such, those institutions must have sufficient expertise to fully understand the nature and extent of the government guarantees supporting their investments. For example, government-guaranteed investments, such as Government National Mortgage Association-guaranteed mortgage-backed securities, are normally highly liquid, because the timely payment of both principal and interest is fully backed by the full faith and credit of the United States government. In contrast, some securities, even if they are labeled as government-guaranteed, are less liquid, because they are only partially guaranteed by the United States government. Consequently, as support for senior tranches erodes, institutions may begin to experience a loss and the securities may become less liquid. Management should perform the appropriate due diligence to understand the extent of the guarantees in its investment portfolio and the amount of risk involved in such securities. Institutions should ensure that they have sufficient expertise in place to fully understand the extent and nature of the guarantee on investments labeled as government-guaranteed.

Stress Testing: Under § 615.5141, mortgage securities are not eligible investments unless they pass a stress test as described in the regulation. An institution must perform stress tests to determine how interest rate changes will affect the cash flow and price of each mortgage security that it purchases and holds, except for adjustable rate securities that reprice at intervals of 12 months or less and are tied to an index. An institution must also use stress tests to gauge how interest rate fluctuations on mortgage securities affect its capital and earnings. An institution must perform stress testing at the time it purchases a mortgage security and quarterly thereafter.

An institution may choose to conduct either a specific three-pronged stress test prescribed in § 615.5141(a) or an alternative stress test as prescribed in § 615.5141(b). Whichever stress test an institution chooses to perform, it must rely on verifiable information to support all its assumptions, including prepayment and interest rate volatility assumptions. The institution must document the basis for all assumptions that it uses to evaluate the security and its underlying mortgages, and it must also document all subsequent changes in its assumptions. If at any time after purchase the mortgage security no longer complies with the stress testing requirements, the institution must divest of it in accordance with § 615.5143.[27]

Section 615.5141(b) requires that an alternative stress test must be able to measure the price sensitivity of mortgage instruments over different interest rate/yield curve scenarios. The methodology used to analyze mortgage securities must be appropriate for the complexity of the instrument's structure and cash flows.

An institution must use the stress test to determine that the risk in the mortgage security is within the risk limits of its board's investment policies and does not expose the institution's capital or earnings to excessive risks. Our preamble adopting the alternative stress test emphasized that a comprehensive analysis may take into consideration a wide range of relevant factors.[28]

The FCA encourages each System institution's board to review its policies concerning the use of an alternative stress test. Board policies should identify which factors are relevant for management to consider when conducting an alternative stress test. These factors may change from time to time as conditions change. From the FCA's perspective, this flexibility is necessary because mortgage markets are often volatile. For this reason, board policies may direct management to consider factors such as credit quality, impact on the institution's market value of equity and asset-liability management, potential for the mortgage market to stabilize, and any other matter the board deems relevant. By considering appropriate factors, System institutions can refine their stress test to fit the desired risk profile of their organization.

In addition, an institution's board policy on investments may specify the factors that are appropriate to determine whether a security passes or fails an alternative stress test. If a security passes some individual tests within the overall alternative stress test but fails other individual tests, the institution's board policy may dictate that the security passes the overall test. An institution's board policy must document, in advance, what factors determine whether a security passes or fails an alternative stress test.

If a mortgage security no longer satisfies the stress testing requirements, it must be divested of in accordance with § 615.5143.[29] Section 615.5143 requires an institution to divest of an ineligible investment within six months unless FCA approves a longer divestiture period. It is not unusual for mortgage securities to fail, then pass, and then fail again stress tests in certain market environments. If a mortgage security fails a stress test but then passes a subsequent stress test before the 6-month regulatory divestiture period has elapsed, the divestiture period terminates. Only if the security fails every stress test within the divestiture period must it be divested of in accordance with § 615.5143, either by divestiture within the 6 months or by seeking FCA approval for a longer divestiture timeframe.

ASSOCIATION INVESTMENTS

Section 615.5142 of FCA regulations implements sections 2.2(10) and 2.12(18) of the Farm Credit Act, which require each funding bank to supervise and approve the investment activities of its affiliated associations. The funding bank may authorize associations to acquire eligible investments listed in § 615.5140, for the purposes of reducing interest rate risk and managing surplus short-term funds.

Funding banks are required to supervise and approve the investment activities of an association. However, as we stated in the preamble when adopting § 615.5142 in 1999:

> Bank oversight does not absolve an association's board and managers of their fiduciary duties to manage investments in a safe and sound manner. The fiduciary responsibilities of association boards of directors obligate them to develop appropriate investment management policies and practices to manage the credit, market, liquidity, and operation risk associated with investment activities. It is incumbent upon each association's investment managers to fully understand the risks of its investments and make independent and objective evaluations of investments prior to purchase.
>
> An association's investment policies should be appropriate for the size, risk characteristics, and complexity of the association's investment portfolio and should be

> based on an association's unique circumstances, risk tolerances, and objectives. Associations must comply with all the requirements in § 615.5133 if the level or type of their investments could expose their capital to material loss. However, an association's board does not need to develop an investment policy if it elects not to hold nonagricultural investments authorized under § 615.5140.[30]

This guidance is still valid today. Because the interest rate risk of most associations is managed by their respective funding banks, interest rate risk at the association level is minimized although not completely eliminated. Consequently, the use of investments for interest rate risk purposes should be limited. Some associations may, however, have surplus short-term funds that they wish to invest. System associations that choose to invest surplus short-term funds should consider the risks involved in purchasing various types of investments. In addition, the duration of the investments should match the availability and duration of the surplus short-term funds.

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[1]This bookletter does not apply to System service corporations, as FCA regulations do not specify any permissible purposes for which service corporations can make investments, or to the Federal Agricultural Mortgage Corporation (Farmer Mac), which is governed by its own investment management regulations in part 652, subpart A of FCA regulations.

[2]Section 615.5140(e) authorizes System institutions to hold other investments (not on the eligibility list) with FCA prior approval. This bookletter applies to all investments held for the purposes authorized by the regulations cited above. Investment management requirements and guidelines covering investments held for other purposes, such as mission-related investments, are imposed in connection with FCA's approval on a case-by-case-basis. They are generally similar to the guidance set forth in this bookletter but are tailored as necessary for the particular investment.

[3]FCA regulatory requirements discussed in this bookletter are found in § 615.5133 unless otherwise specified.

[4]*See* FCA's Fall 2010 Regulatory Performance Plan, available at www.fca.gov. The Regulatory Performance Plan may be found under Laws & Regulations (at the top), FCA Regulations (on the left), FCA Regulatory Performance Plan (on the left).

[5]Section 615.5133(b).

[6]Section 615.5133(c).

[7]*See* id.

[8]*See* id.

[9]*See* FCA Exam Manual EM-520.

[10]Section 615.5133(b).

[11]Section 615.5133(a).

[12]Id.

[13]Section 618.8440 requires each institution board annually to adopt an operational and strategic business plan.

[14]Section 615.5133(g).

[15]Id.

[16]Id.

[17]Section 618.8430 requires each institution's board to adopt an internal control policy that provides direction to the institution in establishing effective control over, and accountability for, operations, programs, and resources.

[18]The Federal Deposit Insurance Corporation (FDIC) issued similar guidance for institutions it supervises. *See* Financial Institution Letter (FIL)-20-2009, at 3-4 (April 30, 2009).

[19]FIL-20-2009, at 6.

[20]Section 939A of the Reform Act requires each Federal agency (with no exclusion for FCA) to modify its regulations to remove any reference to, or requirements of reliance on, credit ratings and to substitute in their place other appropriate standards of creditworthiness. We are considering the application of this requirement to FCA and the System's investments, and institutions should expect that we will address this issue in a future rulemaking.

[21]*See* FIL-20-2009, at 6.

[22]Section 615.5133(f).

[23]Section 615.5140(c).

[24]*See* § 615.5140(c).

[25]*See* FIL-20-2009, at 5-6.

[26]*See* id. at 4.

[27]*See* § 615.5141(c).

[28]64 FR 28893 (May 28, 1999).

[29]Section 615.5141(c).

[30]64 FR 28885-28886 (May 28, 1999).